99/92

PENSION FUNDS IN THE CAPITAL MARKETS

HEARING

BEFORE THE

SUBCOMMITTEE ON TELECOMMUNICATIONS, CONSUMER PROTECTION, AND FINANCE

OF THE

COMMITTEE ON ENERGY AND COMMERCE
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

SECOND SESSION

ON

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PENSION FUNDS IN THE CAPITAL MARKETS

The Impact on Corporate Governance, Trading Activity, and Beneficiaries

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WEDNESDAY, MARCH 19, 1986

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE
SUBCOMMITTEE ON TELECOMMUNICATIONS,
CONSUMER PROTECTION, AND FINANCE,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2322, Rayburn House Office Building, Hon. Timothy E. Wirth (chairman) presiding.

Mr. WIRTH. The subcommittee will come to order.

Today's hearing on the role of pension funds in the capital markets is an outgrowth of the 1985 hearings on takeovers and changes in financial structure. In almost all of last year's hearings, the influence of institutional investors on developments in securities markets was discussed by one or more witnesses. Pension funds are the largest clients of institutional investors and, in the 1980's, the largest source of new savings channeled to securities issuers. These are funds that could be used for startup companies and small and mid-sized companies seeking to expand, which provide the most new jobs for our economy.

Private and public pension and retirement plans now hold in excess of $1 trillion of financial assets. At yearend 1985, they held 21 percent of outstanding U.S.-issued foreign bonds, and 15 percent of U.S. Government securities. While direct holdings of stocks by individuals fell by $400 billion over the period from 1978 through 1985, for a number of reasons, holdings by institutional investors rose by $221 billion, with pension funds accounting for $150 billion of that increase.

What we are seeing in the 1980's is a remarkable and rapid shift in U.S. stock ownership patterns. The rise in the share of total saving through deferred compensation—that is, saving through pension and retirement plans for which employers assume liability—has necessarily altered the relationship between U.S. corporations and their shareholders. Because of indirect ownership through institutional investments, the total number of shareholders is much greater than in the past and includes a broader representation of citizens and a wider spectrum of income levels. But actual control of U.S. corporations is exercised by far fewer individuals.

Currently, institutional investors, as a whole, control well over 50 percent of the shares of large, established companies and it is not unusual for an individual pension fund manager to hold 10 percent or more of the stock in a given company if he or she manages more than one plan.

Because of the size of pension plan assets and the proportion of the shares of individual companies they hold, pension funds now exercise a substantial influence in shaping the national economy. That influence is reflected in: One, the voting of shares on matters of corporate governance and the tendering of shares in corporate takeovers; two, the volume and nature of trading activity attributable to pension funds and the impact of this activity on the trading markets; and, three, the overall level and direction of investments by pension funds and their impact on long-term capital formation and economic growth.

The Employee Retirement Income Security Act, ERISA, enacted by Congress in 1974, set standards of conduct for private pension funds based on their fiduciary responsibility to protect the interests of their beneficiaries.

In fact, our hearings today on the role of pension funds in our economy would not be complete without mention of Jake Javits. Senator Javits considered ERISA one of the most important achievements of his career in public life. I know that all who are participating in this discussion join me in paying tribute to the many contributions of this great man.

ERISA, however, does not address these other questions concerning corporate governance, capital markets, and long-term economic growth. But because pension funds' investments and voting strategies now have so large an impact on financial markets and on the cost of credit, their decisions not only affect the income security of beneficiaries, but also their broader interests as participants in the national economy.

It may be that the most important influence pension funds exert on the U.S. economy relates to their effect on the saving rate. Because high returns to pension funds in one quarter or 1 year may encourage sponsors of defined benefit plans to reduce contributions in the following quarter or year, a rise in the market value of securities may affect the flow of new funds into the capital markets. This could, in turn, affect the availability and cost of financing for businesses, Government, and other sectors of the economy.

Pension funds thus perform critical functions in the economy. On the one hand, they are a tremendous source of capital in the securities markets—capital that could be used by entrepreneurs and small and mid-sized businesses to create new products, new services, and new jobs. And, in addition, pension funds are the accumulated savings and wealth of many individuals—workers in the private sector as well as public employees—who will depend on these savings in their later years as they grow older and retire.

Because the primary function of the corporate securities markets is to fund the long-term capital formation that fuels economic growth and preserves U.S. prosperity and competitiveness, our focus today is on the role of pension funds in the capital markets.

The main purpose of this hearing is to gain insights into ways in which the growth of pension funds may be altering the structure

and functions of securities markets and the market for corporate control. We are asking our witnesses to help us discover what, if any, impact these investors have on the continued relevance of laws and regulations that govern those markets.

As I noted, the subcommittee's 1985 hearings raised a number of issues that we have asked our witnesses to address today. In the area of corporate governance, we are asking specifically whether or not the standards that now guide pension plan managers in voting proxies or tendering shares are adequate, and whether or not beneficiaries should have some role in voting shares.

In addition, some observers have raised the potential for conflicts of interest in the relationships of fund managers and corporate sponsors. Because outside managers have other business relationships with companies whose shares they hold in pension funds, many believe that there are pressures on institutional investors to vote with corporate management rather than in the best interests of pension fund beneficiaries, and that these pressures intensify in takeover situations.

Finally, we have asked witnesses to discuss the effects of large holdings of stocks of individual companies by pension funds or their outside managers on trading activity. A recent issue of Institutional Investor indicated that 23 outside pension fund managers control over $10 billion each of pension fund assets, and that their combined holdings account for over 40 percent of total assets in pension plans. Their dominance could have important implications in terms of the number and diversity of decisionmakers in the market, the interests of beneficiaries and the volatility of trading activity.

Our witnesses today are an unusually diverse and distinguished group, all of whom are uniquely qualified to discuss these issues, and all of whom bring a different perspective, based on long experience, to our discussions.

I will introduce them shortly, but will now turn to my colleagues for other opening statements.

Congressman Luken.

Mr. LUKEN. Mr. Chairman, I think you have outlined many important questions that are going to be discussed that have been raised by the hearings that have been scheduled. What the witnesses here have to say to us today will help the members better understand the increasing presence and role that the institutional investors have in the capital markets of our Nation, particularly the role played by managers of pension funds.

From previous hearings of this subcommittee and from the reports filed with the SEC, we know that institutional investors have rapidly replaced the individual investors, and the amount of funds at their disposal has made the institutional investor an influential, but often mysterious, player in the market. Pensions are one-third of the publicly traded stock in U.S. corporations. That figure is projected to grow to one-half of the stock by the year 2000. Fiduciaries, intermediate fiduciaries, face serious conflicts of interest in trying to vote stock in one client company held in trust for a second client company. These are the kinds of issues that we will want to face squarely today.

Further, there is no monitoring system to guarantee that shares are, in fact, voted and, if so, voted according to the best interests of the pension plan beneficiaries.

Yes, these important issues, how it affects the investing public, the target of these investments, the beneficiaries of the investments, and the Government regulators overseeing the investors and the investments will be topics. Nothing less than the future performance of our U.S. economy is at stake, in the hands of fewer and fewer persons of greater and greater influence—the money managers.

There has been clearly a change in the ecology. The previously existing checks and balances, equalizing forces, have been altered so that the old rules do not have the same effect. What we are going to be looking at today is how aware we are and how aware we should be before the cataclysm which might face us would actually occur.

Mr. Chairman, I believe the discussion from the witnesses will throw some light on these questions. Thank you.

Mr. WIRTH. Thank you, Mr. Luken.

[The opening statement of Mr. Markey follows:]

OPENING STATEMENT OF HON. EDWARD J. MARKEY

Today we return to the issue of corporate governance paying particular attention to the role of pension funds in the trading and voting of stock. As managers of large concentrations of stock ownership, pension fund officers and their delegates often find their hands applied to the rope in the tug-of-war between corporate management and corporate raiders. Willing or not, they are players in a board game called Mergermania, the 1980's version of rolling the dice and landing on either Marvin Gardens or Jail.

I am interested in exploring the significance of delegating voting power from pension fund trustees to investment managers. Does this result in voting patterns any different than what we would expect if the vote were exercised by plan beneficiaries? Under what circumstances have plan sponsors moved to revoke the voting power of their investment managers? Are these situations typically associated with takeover activity?

I have always found it ironic that we have constructed an elaborate set of rules to preserve a shareholder's right to vote on major policy decisions affecting a corporation, yet when it comes to a hostile takeover, we deny that right. One of the consequences of this "voting gap" may be the widespread shareholder approval of defensive tactics proposed by corporate management to prevent sudden takeovers. Many observers have expressed wonder at the willingness of shareholders to approve changes in corporate governance that reduce their control and frequently reduces the value of the stock. Perhaps this is a natural reaction to the knowledge that once a takeover battle begins, shareholders are reduced to bidders at an auction, with little to say about waht gets offered for sale. They would prefer to take steps today to protect against future uncertainty rather than to leave a corporation exposed to the whim of a takeover artist.

I look forward to the comments of the witnesses on this situation as Congress seeks to determine whether our current system of corporate governance is being eclipsed by rapid shifts and increasing concentrations of power in the marketplace.

Mr. WIRTH. Our panel this morning includes a number of distinguished and experienced individuals: Gordon Binns, chief investment fund officer for General Motors Corp., who is also here on behalf of the Financial Executives Institute and the ERISA Industry Committee. Mr. Binns has been with us before. Mr. Roland Machold, director of the Division of Investment, State of New Jersey, cochairman of the Council of Institutional Investors; Robert Scott, executive director, Public Employees Retirement Association of Colorado; Mr. Ronnie Straw, director for development and research

for the Communications Workers of America; Mr. Roger Bransford, managing director, William M. Mercer & Meidinger, on behalf of the Association of Private Pension and Welfare Plans, in Atlanta; Mr. George Cowles, senior vice president, Bankers Trust, also on behalf of the Association of Private Pension and Welfare Plans; Prof. Tamar Frankel, Boston University School of Law; Mr. James Heard, deputy director, Investors Responsibility Research Center; and Mr. Robert Monks, president of Institutional Shareholder Services, in Washington, DC.

We thank you all very much for coming, and I think you all are familiar with the rules of the committee. We would ask you to summarize your testimony in 5 minutes, and we will include your written testimony in full, in the record. The record will remain open for 30 days after the hearing for questions that the subcommittee will have and for comments that you might want to make after the hearing.

We will listen to all of the witnesses and then ask if anyone wants to comment on what the others have said. Thank you for joining us. Let's start with Mr. Binns.

STATEMENT OF W. GORDON BINNS, JR., CHAIRMAN, COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS, AND ALSO ON BEHALF OF ERISA INDUSTRY COMMITTEE; ROLAND M. MACHOLD, DIRECTOR, DIVISION OF INVESTMENT, STATE OF NEW JERSEY; ROBERT J. SCOTT, EXECUTIVE DIRECTOR, PUBLIC EMPLOYEES RETIREMENT ASSOCIATION OF COLORADO; RONNIE J. STRAW, DIRECTOR, DEVELOPMENT AND RESEARCH DEPARTMENT, COMMUNICATIONS WORKERS OF AMERICA; ROGER C. BRANSFORD, ON BEHALF OF ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, ACCOMPANIED BY GEORGE W. COWLES, MEMBER, BOARD OF DIRECTORS; TAMAR FRANKEL, PROFESSOR OF LAW, BOSTON UNIVERSITY; JAMES E. HEARD, WASHINGTON, DC; AND ROBERT A.G. MONKS, PRESIDENT, INSTITUTIONAL SHAREHOLDER SERVICES, INC.

Mr. BINNS. Thank you, Mr. Chairman, and members of the subcommittee. I am Gordon Binns, chief investment funds officer of General Motors. I am appearing before you as the chairman of the Committee on Investment of Employee Benefit Assets, or CIEBA, as we call it, a committee of the Financial Executives Institute comprised of 13,000 financial executives from 6,000 different companies. I am speaking also on behalf of the ERISA Industry Committee, ERIC, which represents over 100 major corporations on matters relating to all phases of their employee benefit plans.

I would like to begin by saying that we appreciate the opportunity to participate in these hearings, as we also have a strong interest in the issues raised by your subcommittee. We believe that the employee benefit system works well, and we welcome the opportunity to explain the operation of the private pension fund system to interested parties such as your subcommittee and staff members.

Our written testimony responds to each of the 15 questions posed in Chairman Wirth's letter of invitation. It also discusses the broader issues raised by the specific questions.

What I would like to do now is focus on several of the issues related to the role of pension funds as investors in the U.S. equity markets, particularly the responsibility for voting proxies of stock held in pension fund portfolios.

First I would like to review just how pension funds vote proxies. Most pension plan sponsors follow the practice of delegating the voting of proxies for stocks held in their portfolios to the investment managers who have the responsibility to manage the portfolios. This practice results from the strong belief on the part of most plan sponsors that prudent investment management includes the voting of proxies because investment managers are hired as prudent experts and because they study and keep track of the companies in which they invest pension funds. The investment managers are best equipped to make an informed prudent judgment of the investment implications of a proxy issue for a particular company.

In addition, because managers are accountable for their overall investment performance, they should have discretion on voting of proxies, since many of the voting decisions have substantial impact on the economic performance of the companies in which they invest.

Delegation of the proxy voting function to the investment managers means that both managers and pension plan sponsors have fiduciary obligations to fulfill. First, the plan sponsors have a responsibility to exercise oversight on the proxy voting by the investment managers by attaining assurances that the managers have an appropriate process in place for making informed and thoughtful decisions on proxy voting.

Second, the investment managers are bound under ERISA to perform the voting responsibility prudently, skillfully, and solely in the interest of the plan participants and beneficiaries.

However, it must be understood that proxy voting is not a science; it is a judgment decision which must take into account the reason a stock has been bought and the reason it continues to be held by an investment manager. As a result, there will necessarily be situations where different managers arrive at different conclusions regarding the appropriate vote to cast for a particular proxy proposal based on their individual reasons for holding the stock. Despite the potential differences of judgment, the investment manager has a clear responsibility under ERISA to act solely in the interest of the plan participants and beneficiaries.

A second aspect of the voting of proxies of stocks held by pension funds is the potential conflicts of interest involving investment managers which may arise from certain types of proxy proposals such as antitakeover measures. ERISA makes it clear that such conflicts must be resolved by the investment managers in favor of the pension plan participants and beneficiaries. To the extent that there are cases in which the manager breaches his fiduciary responsibility to act on behalf of the interest of the plan participants and beneficiaries, ERISA provides the Department of Labor with enforcement authority to remedy such breaches.

A third issue is the degree of concentration of the aggregate voting power as represented by private pension fund ownership of U.S. equities. The Federal Reserve Board estimated that as of June 1985 noninsured corporate pension fund ownership--and this is

just the corporate pension funds—represented about 15 percent of the total capitalization of the U.S. equity markets.

The voting of proxies of that 15 percent aggregate private pension fund ownership is carried out by thousands of different investment managers such that the voting power of those stocks is widely diffused throughout the U.S. economy. There is no definable concentration of power by private pension fund sponsors or investment managers which represents an undue influence over companies or industries in the U.S. economy.

Now, the two other points not related to proxy voting that I would like to emphasize are: First, we do not believe that ERISA requires a strictly short-term-oriented approach to investment results and most plan sponsors do not look at their investment managers in this manner.

The second point is that ERISA permits plan sponsors to invest in small fledgling enterprises and even the very largest pension funds have found ways of doing just that.

In closing, I would like to emphasize that we believe that current laws and regulations safeguard the interests of plan participants and beneficiaries and at the same time promote the proper functioning of the capital markets in our economy.

I would be happy to answer any questions.

[Testimony resumes on p. 27.]

[The prepared statement of Mr. Binns follows:]

STATEMENT OF

W. GORDON BINNS, JR.

My name is Gordon Binns. I am the Chief Investment Funds Officer of General Motors Corporation. I appreciate the opportunity to appear before this Sub-Committee.

I am presenting this testimony as the Chairman of the Committee on Investment of Employee Benefit Assets (CIEBA), which is a committee of the Financial Executives Institute (FEI). The FEI membership is comprised of 13,000 financial executives representing 6,000 of the leading corporations in America, while CIEBA has approximately 30 FEI members drawn from a broad base of industries. CIEBA is currently developing a procedure to extend its membership to other private corporate plan sponsors governed by ERISA. CIEBA was formed in November 1985, with the purpose of serving as a body of information and expertise, and to help develop positions on public policy issues relevant to the investment of employee benefit plan assets.

CIEBA is currently in the process of organizing to develop and disseminate its positions on many issues relevant to the asset management side of ERISA-regulated employee benefit plans. As a result, while this testimony is a fair representation of our position, we may wish to amend or expand on some or all points at a later time as CIEBA deliberations continue.

I am presenting this testimony also on behalf of The ERISA Industry Committee (ERIC). ERIC is a Washington-based organization formed soon after the passage of ERISA and currently represents over 100 major corporate plan sponsors. ERIC has provided testimony and information on a

wide range of employee benefit matters since ERISA became law. ERIC's member representatives participate in all aspects of pension administration.

Background

The Federal Reserve Board estimates that, as of June 1985, the various corporate pension funds in the U.S. had total assets, both insured and non-insured, of approximately $1 trillion. Of the $700 billion representing non-insured assets, approximately 50% was invested in equities of U.S. companies, which in turn represented about 15% of the capitalization of the U.S. equity market.

I have reviewed and discussed with members of CIEBA and representatives of ERIC the set of questions that was provided in Chairman Wirth's letter inviting me to participate in these hearings. As a result of our discussion of these questions, we have identified several broad issues that I would like to address briefly before responding to the specific questions.

One issue of interest to the Subcommittee is the role of proxy voting by pension funds. First, it should be understood that it is the practice of most private pension plan sponsors to have the proxies for shares held in their pension fund portfolios voted by the investment managers that are responsible for investing in those shares. (Investment

managers include independent investment advisors, insurance companies and the trust departments of banks.) While the narrow issue of corporate governance is not specifically addressed in ERISA, with respect to standards of general fiduciary conduct, ERISA clearly states that it is the responsibility of the investment manager to acquire, dispose of and manage the assets for which it is responsible, solely in the interests of the plan participants and beneficiaries (Secti ns 402 and 404).

We feel strongly that prudent investment management includes the voting of proxies, as proxy issues affect the future economic prospects of companies. Because the investment managers are "prudent experts", and because, as part of the investment process, they have been studying and keeping track of the company in which the funds are invested, investment managers are best equipped to make an informed judgment on the investment implications of a proxy issue for that company. In addition, because managers are accountable for their overall investment performance, they should have discretion on the voting of proxies, since many of the voting decisions have substantial impact on the economic performance of the companies in which they invest.

Pension plan sponsors also have a fiduciary responsibility to ensure that proxy voting is carried out in a prudent manner, if that function has been delegated to the investment managers. In general, sponsors responsibly discharge this obligation to exercise oversight on proxy voting if they have obtained reasonable assurances that the managers have an appropriate process in place for making informed and thoughtful decisions on proxy voting.

Closely related to the issue of corporate governance is the issue of whether conflicts of interest can and do arise in the course of evaluating management and shareholder proxy proposals, for either plan sponsors or investment managers and, if so, how the conflicts are resolved.

While there may be instances, particularly with respect to takeover situations, where pressure to vote in one way or another is exerted on an investment manager, the responsibility of the investment manager is clear under ERISA: he must vote proxies solely in the interests of the plan participants and beneficiaries.

A third related area of concern is the degree of concentration of proxy voting power within the universe of private pension plans. As described above, the voting of proxies for stocks owned by pension funds is carried out by thousands of different investment management firms, bank trust departments, insurance companies and pension sponsors and, as a consequence, the voting power of stock is widely diffused throughout the U.S. economy. To illustrate this, as reported in a May 1985 survey by Pension & Investment Age magazine, the largest 200 investment managers of tax-exempt assets ranged in size from $34 billion to $1 billion, and averaged 49% in common stock holdings. While these assets include more than just ERISA-covered pension funds, the stock holdings of the largest manager would still represent less than 1% of the total market capitalization of all U.S. equities. Moreover, as a result of changes in the way plan sponsors put together the group of investment managers for their funds, voting power is more decentralized today than it was years ago. In the 50's and 60's, pension assets were predominantly under the

control of a few large bank trust departments which administered the trusts, invested the funds and voted the proxies. Today, while bank trust departments still handle the administration and custody of assets, the investment management responsibilities and the proxy voting responsibilities tied to investment management are performed by a diversified group of investment managers.

Further, we are aware of no cases that would indicate that overall proxy voting is carried out in any but a reasonable manner or to the detriment of plan participants and beneficiaries. Of course, given the large number of plan sponsors and investment managers, there may be particular instances of abuse or pressure; if so, they are limited in number, and are not systemic. Further, if individual cases of abuse can be identified, there are already remedies under ERISA (Sections 409, 501 and 502) that provide the Department of Labor with strong powers for handling such abuses.

Finally, before turning to the specific questions raised by the Subcommittee, we would like to emphasize that, based on the broad statutory framework that has been in place under ERISA since 1974, the current system is healthy and works well. It allows the sponsors to place the proxy voting responsibility appropriately with those who have control over the investment decision-making process, and provides that all fiduciaries are accountable for their actions. Thus, the interests of the plan participants and beneficiaries, as well as the economy as a whole, are thereby safeguarded.

A senior officer of one large bank trust department has privately summarized this position clearly, as follows: "Proxy voting is an integral part of the investment process. Proxy voting must be done in the best interest of the beneficial owners; and, any 'conflicts' must be resolved in their favor. Proxy voting is not a science, nor is it black and white. Proxy voting is often a judgment decision which is based on the reason a stock is being held. The party best suited to arrive at how a proxy should be voted is the money manager responsible for the stock being held."

Responses to Specific Questions

Q: Does the voting of proxies for stock owned by pension funds play a significant role in corporate governance?

A: It is estimated that private corporate pension funds own about 15% of the outstanding common stock of U.S. companies. Further, proxy voting is carried out by thousands of independent investment managers. There are three basic approaches we would identify for assigning proxy voting responsibility.

Most major private pension fund sponsors have the proxies of companies held in their pension fund portfolios voted by the outside investment management firms that have the investment responsibility for the funds in those companies. These firms are best able to determine what position on a proxy issue will best enhance and protect the value of assets over which they have investment control.

The assets of some other corporate pension funds are invested, entirely or in part, by an internal investment group on the sponsor's staff -- that is to say, these assets are run "in-house". In such cases, the staff, composed of investment professionals, is kept separate and independent of the sponsor's other functions and can thus be viewed as simply another investment manager. Therefore, this approach could be viewed as a special case of the first approach. As such, this group, having the responsibility for investing the funds, would generally determine the appropriate positions and vote the proxies for the shares it had purchased for the pension fund.

Third, a small number of sponsors have arranged for the Master Trustee of the pension fund (or other designated expert third party) to vote the proxies for companies held in all portfolios that comprise the sponsor's pension fund. (A "Master Trustee" is a trustee, usually a large bank, that has custody of the securities and other assets of the sponsor's pension fund but does not have the responsibility to invest the fund's assets - although, in some situations, a portion of a pension fund may be invested by another unit of the bank that serves as the master trustee for the fund.)

Q: Do plan managers take an active interest in the management of companies whose shares they control?

A: Investment managers follow closely the management of the companies in which the investment management firm has invested assets of pension funds, in view of their fiduciary responsibility to do so. As part of the ongoing review process, the portfolio managers or analysts often meet with and speak to the companies' managements to evaluate the outlook for the company. In general, however, neither plan sponsors nor investment managers take an active role in the management of portfolio companies in the sense of placing representatives on boards or in management, or otherwise become involved in influencing corporate business decisions (e.g., plant closings, new product development, etc.).

Q: How -- and how well -- do ERISA and the Department of Labor deal with this issue?

A: Assuming that "this issue" refers to proxy voting, ERISA has set a standard for behavior by fiduciaries -- to act with prudence, skill and solely in the interest of plan participants and beneficiaries. This standard applies to proxy voting as well as to other pension fund matters. Further, under ERISA, to the extent that any individual abuses of this responsibility might occur, authority is provided to the Department of Labor to seek out and take action against offenders. In other words, the legal framework is in place, and we believe that it is satisfactory.

Q: Should there be specific standards to guide fund managers in voting proxies?

A: Under ERISA, both sponsors and investment managers, as fiduciaries, are charged with acting prudently, skillfully and solely in the interests of plan participants and beneficiaries, in proxy voting as in all other pension fund matters. This is the requirement of basic trust law as well. Such a standard establishes a proper balance between safeguarding both the process and the participants' interest and permitting the necessary flexibility to respond to varying situations.

Thus, standards already exist. While the application of these standards is subject to judgment, there does not appear to be any reason to make these standards more detailed or more specific.

Q: Do the fiduciary responsibilities of plan managers require that they tender shares in virtually any tender offer in which a significant premium is offered?

A: No. There may well be instances when the investment manager determines that, in the long run, the interests of the plan participants and beneficiaries are best served by not tendering shares, even though a significant premium is offered. In such a situation, the fiduciary responsibility of the investment manager is to not tender the shares.

It is generally agreed that different investment managers may buy or sell the same stock for entirely different reasons. For example, a manager

may purchase a stock based on a judgment that the company is a takeover candidate and therefore the purchase of its stock would be appropriate as a short-term investment for the portfolio he manages (i.e., the stock should be bought and then sold immediately upon receiving a satisfactory takeover bid). Another manager may have purchased stock in the same company based on the perceived long-term value of the company's assets and thus may decide that existing management will add more value to the assets over the long-term than would be obtained by taking the current cash value for the stock. Investment managers are hired for their expertise in making these types of decisions, which require a balancing of short- and long-term financial and economic interests in order to evaluate the tradeoff between a certain present value and a less certain future value.

Q: Should pension fund beneficiaries have some role in voting shares -- in all cases and types of plans, in some, or none?

A: In practice, plan participants and beneficiaries do have a role in voting shares held in some employee benefit plans. For example, passing through voting rights to individual participants is a widely prevailing practice among those defined contribution plans in which each participant selects the specific stock or stocks to be purchased on his behalf. In addition, participants are commonly given the opportunity to vote shares of the company's own stock that are held by such plans as ESOPs, stock bonus and profit-sharing plans that invest their assets entirely or partly in the employer's stock, and in which the employee has an identifiable interest.

However, passing the proxy voting responsibility to the beneficiary is inappropriate in most other cases. Unless the participant has selected the

specific stock or stocks to be purchased on his behalf, or unless the participant is being asked to vote his own company's stock, he would not ordinarily have sufficient knowledge about the company or the proxy issues to exercise voting rights in an informed and prudent manner. Furthermore, the pass-through of voting rights to participants would generally be inconsistent with ERISA's fiduciary standards, which generally mandate that investment management be assigned to persons with expertise in such matters. We are also concerned that the pass-through of voting rights to participants could have the effect of causing fewer proxies to be voted; professional investment managers are more likely than individual participants to take an active interest in exercising voting rights. Finally, it should be remembered that, except in a limited number of plans, participants have no specific beneficial rights to any specific assets.

Q: Are there specific pressures on fund managers associated with corporate takeovers?

A: In voting proxies for stocks held by pension plans and in making investment decisions on behalf of the plans, it is possible that fiduciaries could be subject to external pressures. As an example, the management of a company could contact investment managers or a plan sponsor's management to attempt to persuade them to support the company management's position in a proxy fight or hostile takeover and endeavor to leverage another relationship with the manager or sponsor (other than ownership) to achieve that support.

However, the responsibility of fiduciaries under ERISA is clear: as takeovers often dramatically increase the price of the takeover target's stock, the fiduciaries must examine each case individually and, based solely

upon the investment implications of the proposals from both shorter and longer term viewpoints, decide whether to support or vote against a proposed takeover. With minor exceptions that should be handled by the Department of Labor, investment managers and plan sponsors take this fiduciary responsibility seriously and comply with the standards set by ERISA.

With respect to a plan sponsor that has an in-house investment staff, there also could be potential conflicts or pressures. However, as described earlier, this corporate staff is normally independent of other corporate functions, partly in order to insulate the investment function from the pressures that could be brought to bear on upper management in situations of conflict such as takeovers. Therefore, as the in-house investment staffs are similarly regulated by ERISA standards, any conflicts must be resolved in favor of plan participants and beneficiaries.

Q: Have there been cases in which decisions by fund managers to oppose or replace corporate management have adversely affected their standing with corporate clients?

A: It is possible that pressures along these lines have been brought to bear by investment managers' corporate clients, but the manager is bound by its fiduciary duty to ignore extraneous considerations. While there may be pressures on investment managers, such pressures can exist in any business relationship. However, more importantly, we have no evidence that any fiduciary breaches have occurred as a result of these pressures, even though it is possible that an investment manager's standing may have been adversely affected.

Q: Should outside managers be barred from voting proxies of companies that are clients? If so, who should vote the shares?

A: No. Barring investment managers from voting the proxies for companies that are clients presumes that the investment manager cannot fulfill his fiduciary responsibility. ERISA's fiduciary standards require the investment manager to discharge his duties under a plan solely in the interests of the participants and beneficiaries in that plan. The manager is subject to civil liability if he fails to meet those standards. In our experience, investment managers conscientiously meet ERISA's standards, and we do not think that there is any demonstrated reason to bar a manager from voting the proxies of a client company.

Q: How -- and how well -- do ERISA and the Department of Labor deal with conflicts of interest?

A: A fiduciary responsible for voting proxies currently has a clear and explicit charge that should enable him to resolve conflict of interest situations -- that is, the requirement under ERISA that the funds be managed solely in the interests of the plan's participants and beneficiaries. This is not to say that two fiduciaries, voting on the same issue, may not arrive at different conclusions and cast opposing votes -- we recognize that thoughtful fiduciaries will at times arrive at different conclusions.

As pension plan sponsors, it is our belief, based upon discussions many of us have had with the investment managers of our pension assets, that investment managers evaluate proxy issues thoughtfully and vote so as to

optimize the investment returns of the plan, thereby acting in the interest of the plan's participants and beneficiaries. Many investment organizations have structured the proxy voting process so as to place the responsibility for evaluating the proxies upon a group of individuals, typically investment professionals, who are involved in, or closely allied to, the actual investment process. Moreover, this group is frequently comprised of senior level portfolio managers and security analysts who have positions of sufficient responsibility to make informed and intelligent judgments.

As to the Department of Labor, if it has evidence that a conflict of interest has resulted in a breach of fiduciary responsibility, it is authorized by ERISA to bring an appropriate action and we believe it would not hesitate to do so.

Q: How do large holdings of the stock of individual companies by pension funds or their outside managers affect trading activity?

A: Evidence indicates that the trading activity of large institutionally-held blocks of shares has surpassed that of the smaller individual holdings. The higher trading frequency of institutional investors may be attributable to the fact that the rate of non-institutional trades tends to be constrained by tax as well as various non-financial considerations, such as the desire to retain ownership control of a family-run company despite any negative investment implications of such ownership. By contrast, investment managers of pension funds are not tax-constrained and further must focus upon only the direct financial consequences of an investment. An important result of the higher frequency of institutional trading activity is that those stocks that are widely held by institutional

managers will tend to be more liquid and have a "deeper", more efficient market, which positively affects individual investors as well as the institutions.

Q: Should there be more explicit standards for asset diversification?

A: No. ERISA (Section 404(a)(1)(C)) provides that fiduciaries must ensure that the plan investments are properly diversified to avoid the risk of large losses. However, as would be expected, there are several reasons why various plans might diversify their holdings differently. Asset diversification is, in large part, a matter of judgment; two equally skilled fiduciaries may have different views as to the proper level of diversification for a particular plan. In any event, pension plans are characterized by wide divergences with respect to demographics (especially size and composition of workforce and retirees), actuarial assumptions and plan maturity and funding, reflecting variations in cash flow requirements and tolerance for risk. Moreover, the appropriate level of diversification may differ as between a defined benefit plan and a defined contribution plan and may also be influenced by the financial stability of the employer and the current and anticipated state of the economy. In short, we think that the standards of prudence and diversification set forth in ERISA are appropriate and permit plan fiduciaries to determine the optimal asset diversification level for each plan in light of its particular needs and circumstances. More specific and inflexible standards for asset diversification could seriously impair a fiduciary's ability to adopt the approach to diversification that is best suited to the plan's particular needs and circumstances.

Q: Should funds of a given size be required to diversify management responsibility?

A: No. As noted above, ERISA requires that plan sponsors safeguard the pension plans against loss through appropriate diversification. Many plan sponsors have responded to this requirement by using different investment managers to provide different investment strategies with respect to a particular class of asset, as well as to manage different types of assets. At the same time, there is no evidence to indicate that funds with more concentrated investment management responsibility have done less well than those funds with a widely diversified manager structure.

ERISA's fiduciary standards require each plan sponsor to consider the question of diversification, but do not mandate that any particular approach toward diversification of management be used. We think that ERISA's fiduciary standards permit a variety of approaches to be used and allow plan sponsors to adopt the approach best suited to the plan and its particular needs and circumstances. We are concerned that specific diversification rules would jeopardize the plan sponsor's ability to adopt the approach best suited to protecting the interests of the plan's participants and beneficiaries.

Q: Do current rules requiring the disclosure of holdings of individual companies provide adequate information? Who benefits from disclosure and is it effective in limiting holdings of individual companies or industry sectors?

A: ERISA already requires pension plan sponsors to file an annual report with the IRS and the Department of Labor (Form 5500), which includes a listing of each of the plan's stockholdings. This information is also available to plan participants.

Other than ESOPs and profit sharing plans that are specifically designed to offer shares in the employer's stock to the employees, we are not aware of any situations where pension funds individually have had a heavy concentration of ownership in an individual company. In fact, under Department of Labor regulations regarding fiduciary responsibility with respect to plan assets, such a concentration of ownership would be questioned under ERISA.

Furthermore, current rules under the 1934 Securities and Exchange Act provide for public disclosure of any concentration of ownership by a pension plan which is made for purposes of gaining corporate control.

Q: **Is the size of some funds a factor that constrains investment options? Is it cost-effective for the larger funds to invest in smaller or less established companies?**

A: The relative size of a plan has been a consideration with respect to evaluating investment options. For example, large amounts of funds cannot be moved quickly between undervalued securities or asset classes without disrupting markets; however, new financial instruments have been developed which reduce this problem and provide greater investment flexibility for plan sponsors. At the same time, a larger asset base provides more flexibility to make investments in less liquid assets, such as real estate, which may provide a higher expected return.

It is cost-effective for larger funds to invest in smaller companies. Investments in smaller companies can be made either with commingled funds held by managers or in an individually managed account. In fact, results have shown that over the long term, small market capitalization stocks have outperformed large market capitalization stocks. Thus, there is a strong incentive for large as well as small funds to invest in small capitalization stocks.

Conclusion

In conclusion, we believe that many of the questions and issues we have discussed today are of a kind similar to those faced and addressed by pension fund sponsors, managers and trustees on a day-to-day basis. The overwhelming majority of pension fund sponsors and fiduciaries scrupulously exercise their responsibilities to maintain and invest pension fund assets for the exclusive benefit of participants and beneficiaries. In this regard, it

should be noted that the standards under ERISA are stringent and are directly relevant to the issues regarding conflicts of interest and corporate governance in the pension fund setting. The important point is that the system requires that plan fiduciaries make an intensive and scrupulous investigation prior to exercising voting rights.

Plan sponsors and fiduciaries who are responsible for making investment decisions on behalf of pension trusts do so in the context of weighing the short-term and long-term interests of the trust as a whole and the participants in particular. This balancing of short-term and long-term concerns is directly in accord with ERISA's fiduciary responsibility provisions and relates to the funding policies and current and future liabilities of the plans. As such, pension funds contribute significantly to private "institutional" savings and hence are important in long-term capital formation and economic growth. Further, the holdings are diffused over many management groups which operate independently.

In short, the fiduciary standards under ERISA, as well as the Department of Labor's enforcement powers and the judicial system's interpretations of those standards, provide adequate systematic protection against possible abusive situations. The current system of reporting and disclosure and fiduciary responsibilities under ERISA is particularly well designed to assure that conflicts of interest are resolved appropriately. It must be remembered that ERISA protects tens of millions of workers and their families and that it is they who are the real beneficial owners of the wealth of corporate America. In short, ERISA and the Department of Labor's enforcement authority and the judicial system's interpretive authority thereunder can and should function as a positive force in assuring the best interests of pension plan participants and beneficiaries and the proper balancing of current financial opportunity and long-term economic concerns.

Mr. WIRTH. Thank you very much, Mr. Binns.

Mr. Machold.

STATEMENT OF ROLAND M. MACHOLD

Mr. MACHOLD. I have a choice of reading quickly or cutting out my comments by about 2 minutes. You may make that choice.

Mr. WIRTH. You have 5 minutes.

Mr. MACHOLD. You've made my choice.

I am director of the Division of Investment, State of New Jersey. I am responsible for investing 99 State funds with total assets of $19 billion. Of this amount, about $16 billion represents the holdings of seven funds held in trust, for 380,000 beneficiaries. The New Jersey pension fund is almost all of the life savings of public employees with average salaries of approximately $19,800 and the retirees have pensions of about $5,000. The number of beneficiaries is 5 percent of the population of the State of New Jersey, and since the funds provide for defined benefits, any shortfall in investment returns must be funded by the taxpayers, which include citizens of the State. I am the fiduciary for thousands of small investors and indeed all of the citizens of my State.

All of our funds are managed by us internally, and we use no outside managers. I am appointed by the nonpartisan State Investment Council. In my role as director of investment I have no affiliation with a political party. I am cochairman of the Council of Institutional Investors, but my remarks today are my own, acting as fiduciary for the funds under my supervision, and do not reflect the views of New Jersey or the present administration in New Jersey.

Issues of corporate governance and efforts to increase investor protection are the primary concerns of the Council of Institutional Investors, which was formed in response to the notorious Texaco and Disney "greenmail" share repurchases. I am one of the three cochairmen of this organization, an organization which was formed specifically to protect security holders' rights and to exercise our independent fiduciary responsibility to our plan beneficiaries.

Our organization has about 40 members, whose investment responsibilities aggregate about $160 billion. The council is open to all institutional investment plan sponsors, including corporate pension funds. It is not our intention to be adversaries of corporate America, but, as investors, to be partners with corporate management. However, it appears that some corporations view us and their other shareholders as adversaries and have taken many initiatives to limit and abridge our rights as securities holders.

The Council of Institutional Investors is not in a position to engage in concerted political action. As fiduciaries, our concerns and individual authority are limited to fiduciary issues, and none of us is in a position to support the political agenda of another party, including each other. We employ no lobbyists or public relations professionals and have no political action committee. In appearing before you and your committee, I am presenting my individual point of view and not a collective point of view.

I cannot address individually the myriad forms of abuses that corporations have initiated—the shark repellants, greenmail, golden parachutes, poison pills, the issuance of nonvoting shares of

stock, staggered boards of directors, et cetera. However, collectively, they represent an assault on the value of our securities. Studies by the Securities and Exchange Commission have shown that various abridgments of voting rights have a direct negative effect on the market prices for stocks, and this effect may be a loss in value of between 1 percent and 5 percent, depending on the nature of the abridgment. In my own experience, the value of a vote may be even higher in certain types of circumstances.

I recognize that these modifications of shareholder rights are often approved by a majority of the shareholders; nevertheless, in every case a minority of shareholders is disenfranchised and future shareholders are bound by the actions of current shareholders.

Furthermore, corporate proxy voting procedures, and the close relationships between corporations, corporate pension funds, and the banks and money managers who serve corporations together mobilize to advance the interests of corporate managers over shareholder interests.

In the absence of voting rights, a share of common stock is merely a feeble security, no more than a perpetual loan without the assurance of any return. The value of the share is at the mercy of corporate management, a management who is no longer accountable to the investor.

It is my contention that the limitation of shareholder voting rights will serve to entrench management, to limit the maximum realization of shareholder values, and to inhibit the vitality of capital markets in the United States.

To date, the council's primary function has been to inform its members of corporate and governmental initiatives which affect shareholders' rights. We met with all parties in the Philips Petroleum contest. We provided a forum for discussing poison pills. We met with representatives of the stock exchanges to express our support for the one-share, one-vote rule. We met with Governor Cuomo of New York to express our opposition to a proposed State law which would have changed the percentage of the shareholder vote required to approve a merger. We met with the Securities and Exchange Commission to discuss these issues.

We intend to promulgate a draft of a shareholder bill of rights for consideration by all interested parties, including other investors, corporate managers, the Securities and Exchange Commission, and any interested Members of Congress and the public. This draft bill of rights will propose that all holders of common stock should have one vote for every share they own, that all common shareholders should be treated equally, that certain corporate issues should be subject to a majority vote of common shareholders, and that the selection of auditors and the establishment of compensation standards should be subject to the approval of outside directors.

Still, we are overwhelmed by the variety and ingenuity of corporate actions which are designed to limit our voting rights and which have reduced the value of our securities. We are shocked that the business judgment rule would be construed so broadly that an executive can claim a $36 million golden parachute for selling his company to a willing buyer. We are appalled that the Delaware court could approve a poison pill mechanism which, if adopted

broadly, would effectively entrench corporate managements and sharply reduce the values that might accrue to shareholders through corporate restructurings or mergers.

Taken collectively, these changes in corporate governance, the judgments of State courts, and the enactment of State laws which protect corporate interests, have unbalanced the covenant which exists between investors, corporate management, and the public interest as represented by the Government. This covenant is the cornerstone of our system of private enterprise and the essential ingredient for dynamic capital markets.

Ten years ago I was concerned that the Government was intruding upon shareholder values and management initiatives through price controls, mandated nonproductive expenditures, and government regulation. Now, in the present laissez faire environment, I am concerned that corporate managements are taking advantage of investors, with the cooperation of local governments and the indifference of the Federal Government. I am here today to ask you to support the investor—all investors, both large and small—to retain this essential covenant between investors, corporate management, and the public interest.

I am often asked whether it is appropriate that corporations should be controlled by institutional investors and other shareholders, and I reply that, within the context of the aforementioned convenant, would you prefer the alternatives of control by either a small group of corporate managers or by the Government? The first would be a return to the oligopolies of many years ago, and the second would be a radical change in our free enterprise system. The investors are the owners of American corporations, and corporate management should be responsive to them and should act to preserve and improve shareholder values.

I am asked whether the investor's goals are too short term to preserve the continuity of corporations, and I reply that investors can and do make long term judgments. In my own instance, I have on occasion voted against Boone Picken's proposals, and in almost all instances I have supported corporate managements against corporate raiders. However, I believe that such decisions should be subject to the consent of the owners of the corporations and should not be the sole prerogative of corporate managements, who would otherwise be free to serve their own personal interests. I would like to add that there is nothing wrong with judgments over the shorter term as well.

The oil industry went through very sharp cyclical changes in recent years, and the managements of these companies were slow to address the overcapitalization and the inventory of unproductive facilities which ensued. The good managements instituted share repurchase programs and liquidated unproductive facilities. The slow ones held back and waited for better times. The bad managements made poor acquisitions, which, for the most part, harmed the shareholder. In every instance the companies should be subject to the discipline of the shareholder vote. And abridgement of that vote will leave the companies accountable only the the Government. This may be appealing to corporate managements at the present time, but in the long run they may feel more comfortable with the shareholder on their side.

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I am asked whether it makes sense for institutional investors to have the authority and power to affect corporate business decisions. My answer is that investors should not intrude upon corporate business decisions, but should have the right of consent to any corporate action which will have a significant financial effect upon a corporation and its shareholders. I would like to be able to vote on specific "poison pill" and similar provisions. I would like to be able to vote on merger proposals which have a significant impact on shareholder values, and I would not like corporate governance procedures to inhibit the presentation of such proposals.

I would like to be able to vote on programs which provide for the incurrence by corporations of large amounts of low quality debt. I would like to be able to vote on a $36 million golden parachute. However, I do not want to do the job of corporate managers. To the contrary, I would like corporate managers to help me do my job by being better financial managers. The corporate managers of today must be as sophisticated in managing their debt and equity capacity as they are in managing their plant capacity. There would be no room for corporate raiders and arbitrageurs if corporate managements were to act consistently to increase shareholder values.

I am asked whether a handful of large investors will act in collusion in order to control corporations. I believe that, under existing State and Federal prudency laws, such collusion is illegal. I am the fiduciary for the funds under my supervision, and I cannot delegate that responsibility to any other group or individual.

I am asked whether the maximization of shareholder values conflicts with a corporation's obligations to its employees and its community. My reply is that a healthy corporation and a healthy community are inseparable and that there are many State and Federal laws already on the books which define these relationships. Still, the corporate manager's primary responsibility is to its owners, and a sacrifice of shareholder interests to the interests of others will only harm all parties in the long run.

By these responses, I have addressed many of the issues raised in your invitation to me. Still, you have raised several other specific questions which I will address briefly. Proxy votes are a significant responsibility for the New Jersey pension funds, a responsibility that I take very seriously. They concern matters which significantly affect the plan beneficiaries and the taxpayers of my State. We have very clear guidelines and procedures for voting proxies, and all of my actions are subject to the consent of a nonpartisan State investment council, which is representative of both the beneficiaries and the broad public interest. We manage all of our money internally, and invest in both large and small companies. The size of our investments and our trading do have an impact on market prices for securities; however, in view of existing prudency law and sound investment practices, we try to minimize our impact by diversifying our investments both over time and across a large number of companies. As a State agency we are not directly subject to ERISA and the Department of Labor. However, I believe that the law has done a great service by promulgating a national prudent person law. Nevertheless, I am concerned that powerful special interests are mobilized to weaken this law and have shifted their efforts from the State level, where beneficiary interests are

fully represented, to the national level, where beneficiary interests may be diluted.

In closing, I would like to thank you for the opportunity of appearing before you today, and would welcome any questions you might have.

Mr. WIRTH. That was phenomenal. It sets an all-time record.

Mr. MACHOLD. Thank you, sir.

Mr. WIRTH. Mr. Scott.

STATEMENT OF ROBERT J. SCOTT

Mr. SCOTT. We are a $6 billion pension fund. We have 41 percent common stock, 22.6 percent corporate and Government bonds, 17.3 mortgages and real estate, and 19.1 percent cash and equivalents. I have my statement in five areas. The first is the voting proxies and tender offers. The second relates to diversification of assets and management of pension portfolios. I will cover these in quite a bit of depth. The next three I can cover very briefly.

No. 1, our current disclosure rules, are they adequate? We think they are. In addition, we publish all of our stock holdings in a comprehensive annual financial report. No. 2, as to trading activity and the size of pension plan holdings, we think it does have an effect. If there are insufficient shares outstanding, it may restrict trading. Also, the use of outside managers to control portfolios we think results in somewhat more volatility for the stocks.

No. 3, as far as ERISA and the Department of Labor, their involvement with whole process, I really cannot comment because we are exempt from the ERISA process. As a public pension fund.

Returning to the first two questions, proxies and tender offers, is it important to overall process of corporate governance, and how do I as a fund manager view it? We think it is important to the overall process of corporate governance because in recent years institutional investors, including pension funds, have become more significant pension owners of corporate America. So if for no other reason, we are bigger players in the game. We take an active interest as managers of our pension fund and the management of companies whose shares we hold because their performance reflects on our performance and because in our case, because we are exempt from Social Security, we are the underlying economic support for a very substantial portion of our State population.

Should there be specific standards to guide fund managers when voting proxies? Yes, we think there should be. We think the sponsors, trustees, and managers should develop such standards. At PERA we have a written board policy concerning the voting of proxies which contain social issues and management policy involving the voting of issues which are perceived to have as their purpose the prevention of takeovers.

Should pension fund beneficiaries have voting shares? We think they should, but with 125,000 members and a lot of proxies coming at us, it is difficult to get their views. But 13 of our 15 board members are elected directly by their constituents, so we have suggested that their reaction to proxies and so forth should be election issues.

Has there been an adverse effect on pension fund managers who vote to oppose or replace corporate management? We think to some

extent there has been some pressure. We have received some, but it has not been significant to this point.

Should money managers vote proxies? We do not think that money managers should vote proxies. We think the underlying holders of the securities should vote proxies, but if outside managers do vote them, we think they should have very specific directions.

Should plan managers tender shares in any tender offer in which a significant premium is offered? We don't think so. We think it depends on the circumstance. If you expect a little bit better deal down the road, you probably ought to wait for it. That is one of your fiduciary responsibilities—one of the things you do when you become a fiduciary.

As to diversification of assets and diversification of management, should there be specific standards for asset diversification? Yes, but we think that should be left to State fiduciary laws. The economic changes that occur and your underlying investment objectives should be considered.

Does large size constrain investment options? Not generally. We don't think so. We have some very small stocks, but it is through venture capital and so forth. But generally, if you are a very large pension fund, it is somewhat difficult if you are managing it internally to spend an awful lot of time on very small companies, but we do that to some extent through venture pools. We do try to commit 17 percent of our portfolio to direct investment in Colorado.

Should funds of a given size be required to diversify management responsibility? We don't think so. We think that can be very expensive and can be very counterproductive, and the same end can be achieved through efficient and effective performance, through performance evaluation, through well-educated and committed trustees, through annual audits and through consulting help.

Thank you very much.

[The prepared statement of Mr. Scott follows:]

TESTIMONY OF ROBERT J. SCOTT
EXECUTIVE DIRECTOR OF
PUBLIC EMPLOYEES RETIREMENT ASSOCIATION
OF COLORADO

MR. CHAIRMAN AND MEMBERS OF THE SUB-COMMITTEE:

Thank you for the opportunity to testify before you this morning. I am the Executive Director of the Public Employee's Retirement Association of Colorado. Our Pension Fund, as of December 31, 1985, had "assets" of $5.6 Billion. These assets consisted of 41% Common Stock, 22.6% Corporate and Government Bonds, 17.3% Mortgages and Real Estate and 19.1% Cash and Equivalents.

We at PERA are very conscious of how and what assets are purchased for our fund. We have an investment policy which is used as a guide for making investment decisions. As we grow in size, our total investment in Common Stocks also grows. A reasonably large position in a single company used to be 10 or 20 thousand shares. Now PERA might own 300 to 700 thousand shares of a single company in some cases. Because of this growth, we are careful to monitor voting proxies of the companies we own. We study corporate proposals carefully in an attempt to ensure that these proposals are in the best interest of the shareholders. In addition, we attempt to determine whether or not these issues will be beneficial to both PERA, as an investor, and the corporation making the proposal. Sometimes, specific tender offers increase the price of a stock, thus increasing our rates of return. On other occasions, we determine that the price offered may not be the best. This is part of our fiduciary responsibility to analyze these proxies and tender offerings. Because of PERA's size, 125,000 members, we feel that it would be too cumbersome for our membership to take a direct role in proxy votes. We encourage them to voice their opinions through their respective Board representative, if they so desire.

Now that our stock positions have increased to about 500,000 shares (approximate average) we are sensitive to various outside pressures from corporations, environmental groups and social groups. By investing in high quality stocks, which are listed in PERA's annual report, we reinforce our investment philosophy of following the Prudent Man Rule by not investing in lesser known or controversial companies.

We invest in companies with a large number of shares outstanding rather than in smaller companies. This allows greater liquidity which, in effect, accommodates us because of the large stock positions that we maintain. If we were to take positions in smaller or less established companies, we would have a very difficult time in doing so. With limited numbers of shares of stock available to buy, we could affect the price of the stock adversely. By diversifying our investments in large, high quality companies, through common stocks, corporate bonds, and real estate, we have been able to maintain very satisfactory investment returns.

PERA, historically, has managed all of its assets "in-house". We have not invited outside money managers to manage any of our assets. As stated, our rates of return have been as good or better than outside managers. These cost savings, which are considerable, are directly passed on to our beneficiaries through improved benefits.

1. The voting of proxies for stock owned by pension funds plays a significant role in corporate governance. Also, the managements of companies, particularly in recent years, have become aware that pension funds can make the difference as to whether or not their company may be acquired by a raider. This has led to managements taking steps to better utilize assets and increase efficiency with benefits to stockholders. Institutional ownership also plays an important part in the valuation of a stock and those companies that are shunned by institutions find their stocks selling at relatively low prices. This has an important impact on their ability to attract members of the management team who are looking for compensation through stock options.

2. Plan managers take an active interest in the management of companies whose shares they own, for funds which they manage, because that makes the difference in their performance. The performance of the pension fund is a determinant of whether or not they will continue to manage those funds. The management of the companies makes the difference in terms of their response to competitive conditions and their ability to operate in an economy which is very difficult to predict. An issue at hand is the foreign competition and the sharp decrease in inflation. Both of these factors have had major impacts on companies. Some of which have gone into Chapter 11 or ceased doing business.

3. There should be specific standards to guide fund managers in voting proxies, but those standards should be the province of the

plan sponsors and/or the trustees of the fund. At PERA, we have a written policy concerning the voting of proxies which contain "social" issues and a management policy involving the voting of issues which are perceived to have, as their purpose, the prevention of takeovers.

4. The fiduciary responsibilities of plan managers insofar as tender offers are concerned would seem to vary by the case. If it were determined that the tender offer was likely to be followed by a higher offer from a third party, even though there was a significant premium, it would probably not be wise to tender. On the other hand, if it appeared that the initial tender offer substantially exceeded the plan manager's perception of fair value, it might be well to tender the shares to the first bidder.

5. It would seem appropriate to allow the pension fund beneficiaries to have a role in voting shares but it would be most cumbersome and expensive. There is a time limit between the receipt of the proxy and the date of the meeting at which the shares will be voted. To poll a large number of beneficiaries, 125,000 in our case, would involve a considerable expense and probably result in the shares not being voted at the meeting. The way in which the beneficiaries can have a role in voting shares is to make that an issue in the election of the directors. Our directors are elected by the fund beneficiaries.

6. We believe that outside managers should be barred from voting proxies of companies who are clients because, clearly, there is a conflict of interest. It would seem that the shares are best voted by the trustees of a particular plan and, in fact, that might not be a bad policy to have the shares voted by the plan sponsors rather than the outside managers. At the least, the plan sponsors should provide a detailed procedure for voting proxies so that the outside managers will not find themselves in a conflict of interest situation.

7. There are specific pressures on fund managers associated with corporate takeovers. One example would be the threat to withdraw funds from the commercial side of a bank whose trust department is responsible for a portion of that company's pension fund. Additionally, there exists the potential for union leaders to threaten political pressure on public funds. There is also the potential for political pressure to be applied by corporations who are active in funding political campaigns and threatening to bring pressure to bear on public funds. Also, officers of companies are aware of their major stock holders' identities, and if senior management felt it would be in their best interest to make contact and apply pressure, they would.

8. The disclosure of holdings of individual pension funds provides adequate information under the current rules. PERA publishes an annual report which lists companies owned. Exactly who benefits from disclusure is not altogether clear and we do not believe it is effective in limiting holdings

in individual companies or industry sectors.

9. Large holdings of the stock of individual companies by pension funds can have a significant effect on trading activity. This can manifest itself in two ways: First, if there are insufficient shares outstanding, it could well restrict trading and perhaps have a adverse effect on the valuation of a particular stock. Secondly, when outside managers of pension funds are large holders, the volatility of a particular issue seems to increase.

10. The standards for asset diversification appear to be well addressed by State fiduciary laws and there does not seem to be any need for more explicit standards for asset diversification. The problem here is that if there were explicit standards that were appropriate in one phase of an economic time frame, it might well be inappropriate during another phase. It would seem that explicit standards hold the promise of causing more harm than good with respect to asset diversification. To set up Federal diversification rules or guidelines for various sizes of Pension funds would be introducing administrative problems. Though the intent is constructive, the application would be burdensome.

11. The size of a fund does not necessarily constrain investment options. Normally, each pension fund has an "Investment Policy" which is used as an operating guide for the pension manager when making an investment decision.It is generally not cost effective for the larger funds to invest in smaller or less established

companies. However, if the fund trustees choose to have a presence in the smaller, less established companies, that can be effected by investing in partnerships or other pooled investments where a manager who is skilled in this particular style of investing can facilitate the investment of substantial amounts of pension fund assets. It is important to note that for large pension funds to invest in smaller companies would be difficult. Companies that have less than twenty million shares outstanding would present a liquidity problems for a large investor.

12. Funds of a given size should not be required to diversify management responsibility because that is not necessarily in the best interest of the beneficiaries. It can be demonstrated that funds measuring in the billions of dollars have been able to perform as well as those of lesser size. Size is not necessarily a criterion of investment performance. Diversification of management responsibility of large funds often results in the same fund buying and selling a given stock to itself as management decisions are made from diverse geographic locations. In addition, unnecessary diversification would be an added cost to the pension fund which, again, is not in the best interest of the fund members.

Mr. WIRTH. Thank you, Mr. Scott.
Mr. Straw.

STATEMENT OF RONNIE J. STRAW

Mr. STRAW. Thank you, Mr. Chairman. My name is Ronnie J. Straw, and I am the director of the development and research department of the Communications Workers of America. Today I would like to discuss the role of beneficiaries in setting pension fund investment and management policies.

The Communications Workers of America is a national union affiliated with the AFL–CIO, representing over 630,000 workers in the communications industry and the public sector. Our union is a party to over 1,000 collective bargaining agreements, and we renegotiate more than 100 agreements each year. The pension benefits of about 500,000 AT&T and Bell Operating Co. workers are covered by Communication Workers' contracts as well as thousands of additional employees in other represented companies. We have a vital interest in preserving the long-term retirement income security for our members, including both current and future retirees.

First, let me briefly describe the provisions of our AT&T and Regional Bell Operating Co., or RBOC, pension plans for you. When AT&T divested its former Bell System Operating Co. on December 31, 1983, eight new pension plans were set up essentially identical to the former unified Bell System Pension Plan [BSPP], in benefits, contributions, and asset mix. The combined assets of these eight independent plans are currently valued at about $27 billion.

The Bell System Pension Plan was first established in 1913 and founded in 1927 with investments only in demand notes of individual Bell System Cos. Common stock purchases were not authorized until 1958, and then were limited to 10 percent of aggregate book cost. The common stock limitation was gradually increased and finally removed in 1967.

While the 1972 Bell System pension fund guidelines suggest that common stock should not exceed 70 to 80 percent of market value of total fund assets, only about half the fund was invested in common stock. As of 1981, 58 percent of the fund was invested in common stock, 28 percent in bonds, 10 percent in cash equivalents, such as Treasury bills, and 4 percent in real estate.

The provisions of our current plans at AT&T and the RBOCs are as follows: All bargaining unit employees who have attained age 25 and completed 1 year of service and who were employed prior to their 60th birthday participate in these plans. The normal retirement age is 65; however, service pensions are provided to eligible employees when the following combinations of age and service are met: age 65 and 10 years of service; age 55 and 20 years of service; age 50 and 25 years of service; and any age with 30 years of service.

A deferred vested pension is provided any employee who leaves AT&T or any RBOC with 10 or more years of service, and who has attained age 32. Also, anyone who leaves at age 65 with 5 to 10 years of service is awarded a vested pension. Unless otherwise elected by the retiree, the normal service pension benefit is re-

duced to 90 percent in consideration of half the reduced amount being paid to a surviving spouse.

The monthly pension amount is determined by multiplying the dollar amount corresponding to the appropriate pension band assigned to an employee by the employee's years and months of service.

Employees are slotted into a pension band according to annual earnings. For example, a telephone operator earning $22,000 per year would be placed in band 107 with a current monthly benefit of $19.85 per year of service. Top craft earning $32,000 per year are in band 123 with a current monthly benefit of $30.53 per year of service. If an operator and top craft had 30 years of service, the respective current monthly pensions would be $596 and $916.

The monthly pension benefit is reduced by 0.5 percent for each month of retirement precedes age 55, unless the employee has 30 or more years of service or is granted a disability pension. A disability pension is awarded any employee who has completed at least 15 years of service, has exhausted 52 weeks of sickness and accidental benefits and is unable to return to work.

All active employees and retirees receiving a service or disability pension are eligible for death benefits. The benefit is equal to 1 year's salary for all active employees. For retirees, the death benefit is equal to 1 year's salary at retirement.

CWA has negotiated pension improvements with AT&T and the RBOCs since 1947. In 1980 we negotiated two pension increases totalling 16.5 percent for retirees and surviving spouses. In 1983 we negotiated another increase of 4.5 percent for retirees and surviving spouses, in addition to two increases totalling 7.1 percent in the pension bands. We expect to negotiate further increases for current and future retirees during 1986 negotiations.

Now let me state our views concerning the role of unions in determining the course of pension fund investment and management. For years, pension funds have constituted the largest single source of capital in the United States. Pension fund assets continue to grow, and pension fund holdings of securities and common stock comprise an increasing share of total United States holdings of these assets.

Because pension funds have grown to such substantial proportions, the way in which these funds are invested can have a significant influence on the composition of our economy and the consequent distribution of benefits to members of our society. Investment decisions of this magnitude can affect monetary flows and interest rates, with the subsequent impact on lending and saving. The mix of domestic industry—manufacturing versus service sector, high-tech versus smokestack, and domestic producers versus multinationals—can be affected by investment choices made by pension plan managers with the resultant impact on the location, type, and quantity of jobs in the economy.

Workers will benefit from pension investments in companies that emphasize employment security, retraining, good labor-management relations, and acceptance of unions, but will suffer employment, income and/or retirement income losses if the bulk of investments are made in antiunion companies with a frequent record of plant closings, layoffs, and shifting work offshore.

While some workers may receive hefty pensions because their pension funds were previously invested in antiunion companies that closed down and moved offshore, hundreds or thousands of workers laid off when that plant closed down will either have to retire earlier than planned with a reduced pension, find a lower-paying job elsewhere with lower pension benefits, or forfeit their service credit toward a pension altogether.

As a union, we at CWA seek to achieve and preserve equity for all Americans, making sure that workers and their families must not unjustly forfeit their rightful and hard-earned benefits. Our goal is to attain employment and income security with a gradually increasing standard of living for all. An adequate and secure income, we believe, should extend throughout an individual's retirement years.

Our main concern is that pension fund assets should be managed and invested in the best interests of the beneficiaries. The beneficiaries are clearly the rightful owners of their pension funds, and are entitled to know where the pension funds are invested. The contributions to the pension funds, whether made by the employer or the employee, are part of the bargained-for wage package and thus belong to the workers. As it stands now, however, most pension fund assets are handled by banks or insurance companies.

It is obvious that corporations remain in control in our society because they have access to information that other groups do not have. We question whether this divorce of ownership and control results in the best possible outcome for the beneficiaries.

The separation of ownership and control of the pension assets, however, involves a potential conflict of interest for the investment managers between serving the interests of the companies to whom they must answer and acting in the benefit of plan participants.

The banks, insurance companies, and other investment advisors who manage the funds are generally empowered by the companies and have no contact with the beneficiaries. For example, section three of the Bell System/CWA pension plan clearly gives the company the right to administer the plan, with no mention of the participants. It reads, in part, "The company shall be plan administrator and the sponsor of the plan." It further gives the company authority to appoint trustees and benefit committees, issue general investment guidelines, and establish and carry out funding policies.

Let me present a few examples of how this conflict of interest can arise. First, the concerns of banks and corporations are drawn closely together through their interlocking directorships. The concerns of pension plan beneficiaries and banks are not reinforced through any similar relationship. The entwined bank and corporate interests could potentially dominate pension plan interests.

Second, a bank could accommodate its trust department's investment activities to assist customers that have large loans or deposits. The bank could use pension fund money to manipulate stock prices to favor its customers.

Finally, banks could accommodate clients by the way they vote the proxies from pension fund investments. Many bank customers may also be companies in which the banks have voting power. I would imagine that the banks seldom, if ever, cast their votes contrary to the wishes of their customers. When questioned by Senator

Howard Metzenbaum in November 1978, during testimony to the Subcommittee on Citizens and Shareholder Rights and Remedies, Jerry D. Minton of the American Bankers Association stated that he knew of no instance when a bank trust department voted against corporate policy. I doubt this has changed since he offered that testimony.

The potential misdirection of pension fund assets convinces me that the workers and retirees, who are the owners of the pension fund, are entitled to effective participation in the management and investment of their pension funds. By effective participation, we mean the ability to actually make policy changes, and not tokenism in any form.

We believe the best way to achieve effective worker participation is to require joint administration of pension funds. All board members would have full rights in selecting and evaluating plan managers and advisers and determining investment policy decisions.

Joint administration would provide workers with information about how their money is being used and ensure that funds are managed fairly, effectively, and in the best interests of the beneficiaries. Investing in corporations that pursue antiunion policies, violate Federal regulations, causing layoffs, unemployment or unsafe working conditions can in no way be construed to be in the best interest of workers.

It seems to me that the goals of providing maximum retirement benefits and investing in socially desirable concerns can both be met through proper investment management policies. Protecting the interests of the beneficiaries can best be accomplished by reuniting ownership and control of pension fund assets, giving the workers an effective voice in the investment and management of the money that is rightfully theirs.

[Testimony resumes on p. 57.]

[Attachments to Mr. Straw's prepared statement follow:]

Preserving the Rights and Income of
Pension Fund Beneficiaries
Statement by
Ronnie J. Straw, Director
Development and Research Department
Communications Workers of America
to the House Subcommittee on Telecommunications,
Consumer Protection and Finance
March 19, 1986

For years, pension funds have constituted the largest single source of capital in the United States. Pension fund assets continue to grow, and pension fund holdings of securities and common stock comprise an increasing share of total United States holdings of these assets.

Because pension funds have grown to such substantial proportions, the way in which these funds are invested can have a significant influence on the composition of our economy and the consequent distribution of benefits to members of our society. Investment decisions of this magnitude can affect monetary flows and interest rates, with the subsequent impact on lending and saving. The mix of domestic industry -- manufacturing versus service sector, "high tech" versus smokestack, and domestic producers versus multinationals -- can be affected by investment choices made by pension plan managers with the resultant impact on the location, type and quantity of jobs in the economy. Workers will benefit from pension investments in companies that emphasize employment security, retraining, good labor/management relations and acceptance of unions, but will suffer employment, income and/or retirement income losses if the bulk of investments are

made in anti-union companies with a frequent record of plant closings, lay-offs and shifting work offshore. While some workers may receive hefty pensions because their pension funds were previously invested in anti-union companies that closed down and moved offshore, hundreds or thousands of workers laid off when that plant closed down will either have to retire earlier than planned with a reduced pension, find a lower paying job elsewhere with lower pension benefits or forfeit their service credit toward a pension altogether.

As a union, we at CWA seek to achieve and preserve equity for all Americans, making sure that workers and their families must not unjustly forfeit their rightful and hard earned benefits. Our goal is to attain employment and income security with a gradually increasing standard of living for all. An adequate and secure income, we believe, should extend throughout an individual's retirement years.

We believe the best way to achieve effective worker participation is to require joint administration of pension funds. All board members would have full rights in selecting and evaluating plan managers and advisers and determining investment policy decisions. Joint administration would provide workers with information about how their money is being used and ensure that funds are managed fairly, effectively and in the best interests of the beneficiaries.

A UNION POINT OF VIEW ON PENSION FUND INVESTMENT POLICIES

BY JOHN D. ABRAHAM, ASSOCIATE DIRECTOR

When the Employee Retirement Income Security Act (ERISA) became law on Labor Day 1974 no one imagined that a small part of the new legislation would garner so much attention in the ensuing years. The section of ERISA which has led to such great debate is Section 404, Fiduciary Duties. This section states that anyone who is responsible for plan investments or plan administration must (1) act solely in the interest of the participants and beneficiaries of the fund for the exclusive purpose of providing benefits and defraying expenses, and (2) act prudently by diversifying plan investments to minimize the risk of loss. The controversy which has arisen over this section of the law has resulted from the recognition that plan participants and plan beneficiairies may in some instances have different interests. The former may want to use fund monies to create jobs regardless of the risk while the latter want risk-free investments to protect their retirement benefit.

In addition to participants and beneficiaries, other organized groups also have more than passing interest in pension fund investment policies. Corporations both large and small are interested, because the over $800 billion in private and public pension plans represents the single largest source of long-term capital in America both today and in the future. How this money is invested can literally make or break any company or industry. Unions are interested in pension funds because they agree to forego direct wage increases for workers in order to meet stated retirement goals. Finally political analysts are interested in pension funds because the directed use of the funds can further specific political or moral causes.

The somewhat divergent interests of these different groups were largely unnoticed until the mid 1970's. In 1974, Peter Drucker jarred the pension community when he suggested that socialism had come to America through pension fund investments, in The Unseen Revolution. Drucker pointed out that pension funds owned about one-third of the equity capital of American business, and predicted that by 1985, the percentage of ownership would grow to 50 percent. Two years later, Randy Barber and Jeremy Rifkin shocked the pension community again with their book The North will Rise Again. These authors contended that Union pension funds from the north-eastern industrial sector of the country were financing the export of jobs to the non-unionized South. Shortly thereafter, pension fund investment policies were again in the national spotlight when the Corporate Data Exchange released a 1979 study entitled, Pension Investments: A Social Audit. This study showed major union pension fund investments in non-unionized companies as well as Equal Employment Opportunity and Occupational Safety and Health violators. Indeed one of the study's major findings was that the AT&T pension fund invested almost $2 billion in traditionally non-unionized companies like Texas Instruments, K-Mart, Halliburton, McDonald's and others. Finally a recent study by the State of California concluded that the state pension fund monies should be invested in California corporations. The sheer size of these assets coupled with their potential use has united everyone's concern with the future of pension fund investment policies.

CWA is concerned about pension fund investment policies since fund monies truly represent the deferred compensation of workers. Union members who are both plan participants and beneficiaries also directly share in the risk of pension fund investment decisions. If the investment earnings are high, contribution levels can be lowered, benefits can be improved or a combination of both can take place. Also active workers can negotiate a larger wage increase and COLA payments for retirees. When fund earnings are low, contribution levels must rise, and the money available for collective bargaining drops. Therefore, CWA members have a direct stake in pension fund investment policies and the rate of return earned on invested sums.[1/]

While CWA members directly share in the risk of pension fund investment decisions, the Union has chosen to monitor pension fund performance rather than take a more active role. This position has served the Union well by permitting it to maintain an arms length bargaining posture with AT&T. However, major environmental changes may lead to a reexamination of this view.

First and foremost on the list of changes is the break up of AT&T and the potential split of the nonmanagement pension fund into at least eight separate funds. Divestiture may place new constraints on contribution levels, as Public Utility Commissions

[1/] Of the several actuarial assumptions used to determine annual pension fund contributions (i.e. disability rate, turnover rate, mortality rates) the interest assumption is among the most important. This is due to the fact that an increase of just one percent in interest earnings can lead to an approximately 20 percent decrease in contributions or increase in benefits. Interest earnings are also important to the pension fund, because they can be directly controlled by fund managers. Disability, turnover, and mortality cannot be controlled to the same degree.

look for ways to hold down subscriber rates. If this happens, workers will be forced to increase their dependence on fund earnings for future benefit improvements. For example, it would be much easier to pay for a 1.6 percent for all years of service pension formula from pension earnings than ask the PUC's for approval to pass on costs. Because of increased PUC resistance to increasing subscriber rates, it is also unlikely that CWA and the new Bell entities will be able to agree to future benefit improvements without substantial pension earnings.

The second major change that has taken place was the establishment of the Bell System Pension Plan (BSPP) for nonmanagement employees and the Bell System Management Pension Plan (BSMPP) for management employees in 1980. Although both funds are presently comingled for investment purposes, the assets of the BSPP are clearly distinguishable from those of the BSMPP. In the past, when there was only one pension plan for both management and nonmanagement, Company negotiators contended that it was impossible to separate the interests of these two groups of employees. This is no longer the case. The bargaining unit employees of AT&T are the owners of the BSPP, and should have a voice in fund investment decisions.[2/]

[2/] There is approximately $17.3 billion in the Bell System Pension Plan (BSPP), and $18.5 billion in the Bell System Management Pension Plan (BSMPP). Together these two plans hold almost $36 billion in assets. Both funds are comingled for investment purposes in the Bell System Trust. AT&T is the administrator and fiduciary of both plans and the Bell System Trust. It selects and monitors performance of investment managers, establishes specific investment policies and objectives. There are currently 13 trustee banks and 106 investment managers. In 1981, the BSPP paid almost $25 million for investment services. The Bell System Trust's asset mix is about 58 percent in stock, 28 percent in bonds, 10 percent in cash equivalents (like Treasury Bills), and 4 percent in real estate.

The third major change that has taken place has been the breakdown of traditional investment strategies. Finance textbooks explain in detail the intuitive notion that risk and return are directly related. Since individuals are typically risk avoiders, a higher rate of return is required as an inducement for more risky investments. This is why savings accounts which protect the principal typically offer the lowest rates of return and common stock which does not protect the principal typically offers the highest rates of return. However, the high inflation rates of the seventies has turned this theory upside down.

Table I shows that rates of return on Treasury Bills, Government Bonds and the Soloman Brothers Corporate Bond Index exceeded the return earned on the Standard and Poor's composite index of common stocks between 1970 and 1978.

TABLE I

Comparative Rates of Return: Common Stocks, Corporate Bonds, Government Bonds, and Treasury Bills

	Common Stocks	Corporate Bonds	Government Bonds	Treasury Bills
1970	4.0%	18.4%	12.1%	6.5%
1971	14.3	11.0	13.2	4.4
1972	19.0	7.3	5.7	3.8
1973	-14.7	1.1	-1.1	6.9
1974	-26.5	-3.1	4.4	8.0
1975	37.2	14.6	9.2	5.8
1976	23.8	18.6	16.8	5.1
1977	-7.2	1.7	-0.7	5.1
1978	6.6	-0.1	-1.2	7.2
Average annual rate (1970-1978)	4.5	7.5	6.3	5.9

Source: Roger G. Ibbotson and Rex A. Sinquefield, Stocks, Bonds Bills, and Inflation: Historical Returns (1926-1978). Charlottesville, Virginia, 1979.

Moreover, A.G. Becker, Inc., a brokerage house that montiors pension fund performance, has consistently found that the 3,500 pension plans in their sample produce lower returns on investment than other investors. Over the 1961-1981 period, Becker reports that the rate of return on equities in their pension fund sample earned a rate of return of 6.7 percent. Over the same time period, the annual average return for the Standard and Poor's 500 was 7.5 percent. This means that if the investment managers had placed all their money in the S&P 500, the fund would have earned almost one percent more. Results like these bring into question the wisdom of investment managers to predict market trends and suggest that heavy involvement in the stock market may not be a good idea for either plan participants or beneficiaries.

Whether the theoretical relationships between risk and return will reappear or the current relationship continues into the future is a serious question facing all pension funds. Incorrect investment choices will certainly have an adverse impact on both plan participants and beneficiaries. Because of the major consequences of this decision, the Union should be involved in future investment choices.

The fourth major change that has taken place is the growth in longevity of Americans. As mortality rates continue to drop, an ever growing number of individuals now expect to retire and receive a pension. In 1940, only about 47% of all men and 55% of all women were expected to reach age 65. By 1979, the percentage of men and women expected to reach age 65 grew to 65% and 79% respectively. Moreover, workers who retire today have a longer life expectancy than their parents. Average life expectancy

in 1940 for males and females age 65 was about 12 and 14 years respectively. By 1979, life expectancy rates grew to 14 years for men and 19 years for women.

Evidence of this trend at AT&T appears in the retiree to active employee ratio which has been increasing over time. While the data limitations prevent complete accuracy, it appears that the ratio increased from about 15 percent in 1975 to around 20 percent by 1981. As this ratio increases, contribution rates will be forced to increase as well.

These four major developments coupled with the shear size of the BSPP fund certainly challenge us to rethink our traditional position. But if the Union were to take a more active role in fund investment policies, what type of role would it play? First, we would insist that the fiduciary duties of ERISA be met. This means that pension fund assets must be managed and invested in the sole interest of participants and beneficiaries and that plan investments by truly diversified. Second, we would insist that the pension fund investment strategy take a long-term view on investments. This would better protect the principal and guarantee high and stable earnings. To meet this objective, the current percentage of fund common stock holdings would have to

be significantly reduced.[3/] Third, the Union must have effective participation in pension fund investment policy. By effective participation, we mean the ability to make actual policy changes.

There are several ways in which Union participation could be effected. One way would be to negotiate a multi-employer pension plan. This action would automatically require joint Union and Management trusteeship of fund assets. This could also solve many of our other concerns raised by the proposed restructing of the BSPP. Alternatively, a joint Union/Management pension board could be created. All board members would have full rights in selecting and evaluating managers and determining investment policies. A variation of the joint board concept would protect participants' interests through appointment of a neutral party like university professors to the board. Another option would provide the Union an opportunity to formally review the investment decisions made each year and recommend changes in investment policies and investment managers.

Regardless of the type of involvement that is chosen, the Company and Union should negotiate investment guidelines into the contract. This concept is especially interesting because it

[3/] A spot check of rates of return on AT&T pension fund assets in the years 1975, 1978, and 1981 show earnings of about 2%, 5%, and 7% respectively. These returns generally follow stock market performance those years and reflect the market's volatility. Longer term investments would help stabilize the rate of return, and may provide even higher earnings.

could instill Union principles into plan investment decisions without requiring direct participation in fund management. Such a policy statement would give investment managers clear directions to follow. It would also provide Union and Company analysts with readily identifiable yardsticks for measuring manager performance.

In addition to incorporating the three overall union policy goals into the guidelines, we could also suggest the following specific objectives be pursued:

1. Up to ten percent of fund assets could be invested in direct home mortgages for qualified participants and beneficiaries at one percent below conventional FHA rates.
2. Up to ten percent of fund assets could be invested in direct personal loans to plan participants and beneficiaries up to $5,000 at one percent below current market rates. (Both mortgage and personal loan monies could be made available through the various Company and Union sponsored credit unions around the country.)
3. Up to ten percent of fund assets could be invested in electronic, computer and other job creating vocational schools provided that (1) both the Company and Union directly participate in curriculum development and (2) plan participants receive free tuition.

4. Consideration should be given to increase plan investment in Bell System securities up to the 10 percent legal limit imposed by ERISA. (In 1978, the Bell System pension plan invested only around four percent of total assets in the Bell System securities.)
5. No pension fund monies shall be invested in any substantial competitor. Maintaining stock or purchasing new holdings in companies like IBM or Texas Instruments would clearly not be in the best interest of either plan participants or beneficiaries in light of divestiture.

The pressure for Union participation in pension fund investment policy will continue to grow. The question is what form will it take. Union and Company leaders, plan participants and beneficiaries should begin to consider issues raised in the literature so that a consensus course of action can emerge which reflects the objectives of all interested parties.

SUMMARY OF "ACTUARIAL GAINS, DEDICATIONS EASE CORPORATE CONTRIBUTIONS,"
PENSION AND INVESTMENT AGE
APRIL 4, 1983

The article reports on the different investment vehicles and techniques used by several corporations to hold down the cost of their pension programs.

These companies utilized dedicated bond portfolios which match bond coupons and maturities to expected benefit payments. This practice eliminates reinvestment risk and locks in a rate of return. For example, United Brands Company set up a bond portfolio which earns more than 15 percent and justified raising its pension plan's interest rate assumption. The result was that the required contribution from United Brands was reduced. Similar moves were made by Honeywell, Inc. and Firestone Tire and Rubber Co. Though the article does not suggest this, such an investment move could also justify benefit improvements.

Annual reports show savings

Actuarial gains, dedications ease corporate contributions

CHICAGO—**United Brands Co.** dedicated a bond portfolio for its pension fund, making it one of several companies reporting a savings in fund contributions in their 1982 annual reports.

United Brands manages its $10 million bond portfolio internally but employed Salomon Bros. Inc., New York, for the computer program that matches the fund's liabilities to bonds in the portfolio, according to William Friedel, director of treasury services.

Because the bond coupons and maturities match benefit payments, reinvestment risk is eliminated, locking in a return. Actuaries have allowed dedicated portfolios, a popular investment in 1982, to justify an increase in the assumed investment income earned on the dedicated plan assets, decreasing the required contribution.

United Brands set up the bond portfolio which earns more than 15%, in June. Mr. Friedel said. The annual report states the food products company saved $4.5 million by raising its interest assumption. The portfolio brought the plan's average return assumption to 8.7% in 1982 from 8% in 1981.

The savings in pension expense was not subtracted from pension expense, but was "included in other income and expense," the report states. Pension expense was $16.6 million in 1982, $15.6 million in 1981 and $20.5 million in 1980. At the end of June 1982, the plan held $215.3 million.

Honeywell Inc. also dedicated a portfolio in 1982. It earns 15.6% and led to a $9.8 million reduction in pension expense, Honeywell's 1982 annual report states. The net result of this reduction combined with other cost increases was to lower pension expense to $91.5 million in 1982, from $94.3 million in 1981. On June 30, the plan held $787.7 million.

Firestone Tire & Rubber Co. enjoyed actuarial gains for the second year. "Domestic pension expense in 1982 was further decreased by $13 (million) due to an increase in the assumed rate of return for the active and (retired) employees," the tire maker's report states. This partly was offset by higher costs for improved benefits. Firestone has set up some dedicated portfolios in its fund.

Firestone's pension expense was $18 million in 1982, when it used a 9.8% return assumption, $44 million in 1981, with a 9.2% return assumption; and $65 million in 1980, with a 7.5% return. On Oct. 31, Firestone's plan assets exceeded $1 billion.

Mr. WIRTH. Thank you very much, Mr. Straw.
Mr. Bransford.

STATEMENT OF ROGER C. BRANSFORD

Mr. BRANSFORD. Thank you. Good morning, Mr. Chairman and members of the subcommittee. I am Roger C. Bransford, managing director with William M. Mercer-Meidinger. Joining me today is George W. Cowles, senior vice president of the Bankers Trust Co. and a member of the board of directors of the Association of Private Pension and Welfare Plans, or APPWP.

APPWP's membership includes over 475 large and small plan sponsors, as well as representatives of the entire range of service providers which support the private benefits system: banks, insurance companies, accounting firms, actuarial firms, investment management firms, and benefits consulting firms.

The benefits community is proud of the secure and financially sound benefits system that has evolved in this country over the last 30 years; its continued vitality—indeed its survival—depends on the increased economic efficiency of its delivery system and on the expansion of creative investment choices to maximize returns on the enormous funds held in trust for retirement, health, and welfare benefits for American workers.

In our view, it is critically important to insure that the resources allocated to providing benefits be maximized and that the administrative costs of operating plans be kept to the minimum level possible in relation to the benefits provided.

The subcommittee's hearings today will focus on the role of pension funds as investors in the securities market, in particular, problems arising with corporate governance and trading activities. As noted in your invitation to testify, pension funds today have significant holdings in corporate stocks and bonds. We believe, in general, that ERISA fiduciary rules—which subject plan sponsors and their delegates to strict standards—provide adequate safeguards against potential abuses which may occur in corporate governance and trading activities. As we will expand upon in answers to the questions your subcommittee has posed, we see no need, at this time, to propose changes in the laws relating to corporate governance and trading activities for pension funds.

Before answering the questions outlined in your invitation to testify, I would like to generally describe the structure of ownership of employee benefits funds under ERISA. Employee benefit plans are established by executing a written plan document and usually funded through a trust. The trust is a separate legal entity and is the "legal" owner of the plan assets. ERISA provides that every employee benefit plan must designate a named fiduciary who has ultimate responsibility for the plan and trust. In a single employer plan, the plan sponsor is generally the named fiduciary, while in multiemployer pension plans control resides in a board of trustees composed of labor and management who act as the named fiduciary.

Typically, the named fiduciary delegates responsibilities to trustees and investment managers, but retains the oversight responsibilities for the entire employee benefit program. In all cases a named

fiduciary under ERISA exercises ultimate control and has ultimate responsibility for the operation of the employee benefit plan.

The following discussion sets forth the questions you have posed, and our answers. We have attempted to address every question but, of course, we are not familiar with some areas and, therefore, our answers may not be as extensive. Moreover, since we represent primarily single-employer plans, our focus today will be on such plans. Finally, we would be glad to provide you any further assistance your subcommittee may desire.

I would like to talk about three general areas. The first is corporate governance, the second is professional investment management, the third is voting.

With respect to governance——

Mr. WIRTH. We have a vote that is now going on, and I had hoped that Mr. Luken could get over to vote and back here again so I could go vote. If you would suspend briefly, Mr. Luken will be right back in the chair.

Mr. BRANSFORD. Fine.

[Brief recess.]

Mr. LUKEN [presiding]. The subcommittee will reconvene. We apologize for the inconvenience, and the seemingly ridiculous procedures we go through. There must be a reason for them somewhere.

Mr. Bransford, would you proceed?

Mr. BRANSFORD. Yes, sir.

Mr. LUKEN. I understand Mr. Cowles is with you and you are at the moment speaking.

Mr. BRANSFORD. Yes; I will continue from the point where I left off. There are three general areas that we would like to address: corporate governance, professional investment management, and voting. The first area will be in corporate governance.

We start with the proposition that plan sponsors as well as named fiduciaries for a plan in their investment managers to whom they delegate authority have an obligation under ERISA to monitor plan asset investments with an eye toward maximizing returns over the long term exclusively in the interests of participants and beneficiaries. These plans are investors, they are not management nor can they substitute their judgment for management.

Even the largest plans generally own far less than 1 percent of the outstanding shares of a particular company, and in a large portfolio of 2 to 300 hundred companies invested in, it is impractical and self-defeating for a plan to do anything other than sell its shares when, in the view of the plan fiduciary, management is following a course which may not maximize the long-term investment potential of the shareholders.

There may be times as well when the plan sponsor, as named fiduciary, has delegated its voting power to an investment manager and in the course of the duty to monitor the performance he decides that the purposes are inconsistent and then the named fiduciary has an obligation to correct the managers by direction or by voting the shares himself.

In our view, the obligations set forth under ERISA are sufficient to ensure that participants are protected and plan shareholders are as vigilant and effective with respect to issues of corporate govern-

ance as any other prudent investors would be under the circumstances.

A pension plan is a long-term enterprise. Assets are accumulated over the entire working lives of participants to provide an adequate retirement income. Sometimes realizing short-term gains in the plan's best interest and thus, for example, there can be no simple answer to your question whether a plan should always tender its shares when a significant premium is offered. The answer lies in determining whether the premium is significant enough to offset longer term expectations for the price of the shares. We see no need for any special standards, nor do we think that in the numerous possible factual contexts in which these questions arise any one set of standards could be universally applicable.

The duty to act exclusively in the interest of participants and beneficiaries is the highest duty under trust law. And there are no easy standards or guidelines which could insulate a fiduciary when he fails to meet this obligation.

With respect to professional investment management, several of your questions address the potential conflicts of interest and pressure that may be brought to bear on investment managers. We recognize that managers who are responsible for several different plans may have a more complicated decisionmaking process. Their obligation with respect to each of the plans is still the same: to produce a return consistent with the investment goals of the plan. If conflicts exist, they should of course be disclosed to all parties.

We do not agree that the conflicts will inevitably be disabling in terms of the manager performing his obligations consistent with ERISA. The fiduciary provisions of ERISA themselves recognize the potential for conflict. Section 408(c)(3) especially provides that nothing in the prohibited transactions provisions of ERISA shall be construed to prohibit any fiduciary from serving as a fiduciary in addition to being an officer, agent, or other representative of a service provider or plan sponsor or other party with interests with the plan. When he fails to understand that he wears two different hats with two fundamentally distinct sets of obligations, the Department of Labor or the participants have been quick to bring legal action to remind him, as was the case of litigation brought by both the department and the plan participants against Harold Simmons a few years ago.

If an investment manager standing with his corporate clients is adversely affected—and we do not doubt in some cases it has been or could be—that is ultimately the risk one takes in wearing two hats and in no way undermines the obligation of the manager to act in accordance with the fiduciary requirements of ERISA.

Finally, we would like to say a word or two on voting. The obligation to vote comes with the ownership of shares in a company. It does not transform plans, which are mere investors, into management. The question of who should vote must be answered differently, depending on the type of plan which holds the shares. We cannot endorse the notion that participants should routinely direct the voting of all shares of their plan.

For example, in a defined benefit plan, the ultimate risk taker with respect to an investment is the plan sponsor who will be obligated to contribute additional funds to make up for the losses in-

curred with respect to any soured investment. In a defined contribution plan, while the risk is on the participants, they are protected by the fiduciary obligation of the plan fiduciary to vote prudently and to decide whether the stock should be sold or retained by the plan.

We urge you not to overlook the practical aspects of passing through the vote to participants and the cost to the plan of distributing proxy materials informing participants of other relevant information and obtaining the necessary participant direction.

In our view, the cost of the process, when one considers 50 million participants, an average of 100 equities per plan at a plan cost of $1 per each proxy printed and mailed, it may outweigh any possible investment gain which could be derived from allowing participants to manage plan assets. An additional $5 billion administrative cost on plans can only diminish the benefits that American workers can expect to receive.

In sum, we think ERISA is working. A lot of law and practice has been built up around the questions of fiduciary responsibility, conflict of interest, asset diversification, and independent management. As we noted at the outset, we see no reason to overturn these standards or to craft new standards which may have the effect of hurting rather than protecting plans in the marketplace. How plans invest and manage assets is a question unique for each plan and allowing plan professionals to make their decisions with flexibility but consistent with requirements of ERISA seems to us to be the best method of ensuring that retirement promises to workers are best fulfilled.

We would be happy to address any questions you may have.

[Testimony resumes on p. 77.]

[The prepared statement of Mr. Bransford follows:]

TESTIMONY OF THE

ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

Mr. Chairman and members of the Subcommittee, I am Roger C. Bransford, Managing Director with William M. Mercer-Meidinger. Joining me today is George W. Cowles, Senior Vice President of the Bankers Trust Company and a member of the Board of Directors of the Association of Private Pension and Welfare Plans ("APPWP"). The APPWP's membership includes over 475 large and small plan sponsors, as well as representatives of the entire range of service providers which support the private benefits system: banks, insurance companies, accounting firms, actuarial firms, investment management firms and benefits consulting firms. The benefits community is proud of the secure and financially sound benefits system that has evolved in this country over the last 30 years; its continued vitality -- indeed its survival -- depends on the increased economic efficiency of its delivery system and on the expansion of creative investment choices to maximize the returns on the enormous funds held in trust for retirement, health and welfare benefits for American workers. In our view, it is critically important to insure that the resources allocated to providing benefits be maximized and that the administrative costs of operating plans be kept to the minimum level possible in relation to the benefits provided.

The Subcommittee's hearings today will focus on the role of pension funds as investors in the securities market, in particular, problems arising with corporate governance and trading activities. As noted in your invitation to testify, pension funds today have significant holdings in corporate

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stocks and bonds. We believe, in general, that ERISA fiduciary rules -- which subject plan sponsors and their delegates to strict standards -- provide adequate safeguards against potential abuses which may occur in corporate governance and trading activities. As we will expand upon in answers to the questions your Subcommittee has posed, we see no need, at this time, to propose changes in the laws relating to corporate governance and trading activities for pension funds.

Before answering the questions outlined in your invitation to testify, I would like to generally describe the structure of ownership of employee benefits funds under ERISA. Employee benefit plans are established by executing a written plan document and usually funded through a trust. The trust is a separate legal entity and is the "legal" owner of the plan assets. ERISA provides that every employee benefit plan must designate a named fudiciary who has ultimate responsibility for the plan and trust. In a single employer plan, the plan sponsor is generally the named fiduciary, while in multi-employer pension plans control resides in a Board of Trustees composed of labor and management who act as the named fiduciary.

Typically, the named fudiciary delegates responsibilites to trustees and investment managers, but retains the oversight responsibilities for the entire employee benefit program. In all cases a named fiduciary under ERISA exercises ultimate control and has ultimate responsibility for the operation of the employee benefit plan.

The following discussion sets forth the questions you have posed and our answers. We have attempted to address every question but, of course, we are not as familiar with some areas and therefore, our answers may not be as extensive. Moreover, since we represent primarily single employer plans, our focus today will be on such plans. Finally, we would be glad to provide you any further assistance your Subcommittee may desire.

1. Does the voting of proxies for stock owned by pension funds play a significant role in corporate governance?

The voting of pension proxies does play a significant role in corporate governance because many large publicly owned companies have from 30-60% of their shares owned by pension funds collectively. However, individual pension funds generally own less than 1% of the outstanding stock of any particular company in their portfolios. Thus, because individual funds own such a small portion of each company, the individual plans by themselves have very little impact on corporate governance matters.

The plan sponsor of a single-employer plan -- generally the named fiduciary -- has the right to vote the securities or to delegate the voting power to its investment managers. Most plan sponsors have delegated the voting power to their investment managers, reasoning that the managers have researched the companies, know the management, and know the issues to be voted. It would be difficult and time consuming for the plan sponsor to know enough about the 150-300 stocks

held by the typical large fund to vote them intelligently. These plans are investors; they are not management, nor can they substitute their judgment for management's.

While ownership of companies is spread out among many different pension plans, the actual exercise of voting power may be more concentrated because the power to vote proxies has been delegated to their investment managers. Thus, investment management organizations are in position to vote shares on behalf of several clients which in the aggregate will represent a higher percentage of the total ownership of a company. For a giant investment manager, the aggregate voting power exercised on behalf of pension clients may be as high as 15-25% of the shares.

In general, we believe that this delegation has not caused any major problems in the market place. When a delegation is made to the investment managers, the plan sponsor has a responsibility to see that the voting power is exercised in accordance with the standards established under ERISA. In those cases in which it is the judgment of the plan sponsor that the investment manager is not carrying out voting responsibility in a satisfactory manner, it is appropriate for the plan sponsor to revoke or supersede the manager's voting power. In recent years, particularly in a number of takeover situations, several plan sponsors have revoked the voting power of their investment managers because they disagree with the decisions of these investment managers. In such cases, the plan sponsors have concluded that the investment managers are

too short term oriented and have been making voting decisions that are not in the long term interest of the pension plan or even of the U.S. economy.

2. Do plan managers take an active interest in the management of companies whose shares they control?

As we stated in our first answer, generally, individual plans do not control companies. In addition, we know of no instance where individual plan sponsors attempted to "pool" their ownership interests. The plan sponsor and its investment managers look at the investment in a company as a means to an end, i.e., to build a fund to pay benefits to plan participants. Beyond the control issue, plan sponsors and their investment managers cannot be expected to take an active interest in the management of the companies whose shares they own. Since the typical large pension fund has investments in 150-300 companies, it would be impractical to be actively involved in the management of so many companies. If a plan loses confidence in the management of equities it holds, and believes that the value of their shares will not increase, the only practical solution is to sell the shares of a company where there is no support for management.

3. How -- and how well -- do ERISA and the Department of Labor deal with this issue?

ERISA's fiduciary principles clearly delineate the plan sponsor's fiduciary responsibilities. The named fiduciary has the right to vote shares or can delegate the voting power, but must monitor its outside managers to ensure that a good

delegation has been made. The Department of Labor has had no reason to get involved in this area until the numerous takeover attempts began in the last few years. At this time, we believe ERISA provides adequate safeguards and the Department of Labor has performed satisfactorily in regards to their responsibilities.

4. Should there be specific standards to guide fund managers in voting proxies?

Since, in most cases, the named fiduciary has delegated the voting of pension proxies to investment managers, the investment managers by necessity have had to develop specific standards for voting. Very few plan sponsors have had a reason to review and question the guidelines established by their investment managers until the recent activity in takeover attempts. Several of these takeover attempts have exposed fundamental disagreements between plan sponsors and their investment managers on what is in the best long term interest of the U.S. economy.

In our view the issue is not whether standards should be established but who should set the standards. In this regard we believe the named fiduciary should have the responsibility for setting specific standards for voting proxies, or to delegate and review such standards.

5. Do the fiduciary responsibilities of plan managers require that they tender shares in virtually any tender offer in which a significant premium is offered?

The investment manager's job is to maximize return consistent with prudence as he works for the ultimate interests of the plan participants and beneficiaries. If it is clear that a tender offer has a signficant premium built in and the investment manager does not anticipate a further increase in price, he should tender to maximize return.

However, investment decisions normally are made within a longer term time horizon as pension funds are expected to continue indefinitely. The problem is in determining that the premium is significant enough to offset longer term expectations for the price of the stock. If the investment manager concludes that the proposed merger will not be advantageous for the security in questions, he should not tender.

It is often not clear that a short-term gain based on a premium tender offer is the best course to follow when considering longer range goals and objectives.

Accordingly, this issue boils down to just another investment decision which each manager must deal with based on his own analysis of the situation.

6. Should pension fund beneficiaries have some role in voting shares -- in all cases and types of plans, in some, or none?

Our answer to this question differs depending on the nature of the plan involved. In the case of a single-employer defined benefit plan, the plan sponsor promises the participant a benefit upon retirement. The plan sponsor sets aside money to fulfill that promise. The money is normally invested in securities. As we have previously stated, often investment managers control the purchase and sale of securities and normally are charged with voting the proxies as they should be most familiar with the company involved and better able to make a judgment on proxy matters. Accordingly, in a single-employer defined benefit plan, the plan participant or beneficiary should not be involved in any investment decisions, including proxy voting.

On the other hand, a case may be made that in a defined contribution plan, participants and beneficiaries have a more direct interest in the success of the companies whose securities are held, as they bear the investment risk. Carrying this reasoning further, where stock of the plan sponsor is held in the fund (a company stock profit sharing plan or an ESOP arrangement), pass-thru voting might well be appropriate. Indeed, many such plans do provide for pass-thru voting to participants.

In multi-employer pension plans, the Board of Trustees, as named fiduciary, has ultimate control. Normally,

it delegates proxy voting to the investment managers. However, if the trustees are not satisfied with the investment managers' voting, they may either vote the proxies themselves or possibly delegate the voting responsibilities to a special committee.

It would be extremely costly and inefficient to provide for participants or beneficiaries to vote proxies on a diversified portfolio of securities. First, beneficiaries do not have the analytical skills or financial information necessary to properly evaluate the issues. Second, there are millions of participants covered by employee benefit plans and plans own thousands of securities. The logistics of mailing thousands of proxies to millions of participants is staggering. Even more troubling is the cost of distributing the proxies to participants, and the effect of that additional cost on benefits. Thus, for example, assume that 50,000,000 participants are entitled to vote proxies of, on average, the 100 equities owned by their plans. If the cost to the plan of printing and mailing proxies is $1.00, the total cost to plans is $5 billion. In defined contribution plans, participants bear this cost directly, and their account balances, and ultimate retirement income will be reduced to reflect it. Even in defined benefit plans, where this additional administrative cost will fall, in the last analysis on the plan sponsor, he will surely take the cost into account in considering the viability of benefit improvements. Finally, experience has indicated that even in company stock profit sharing plans,

participants rarely vote more than 30% of the plan's holdings of company securities.

Accordingly, with the possible exception of company stock profit sharing plans or ESOPs, it is not practical to provide for pass-thru voting to beneficiaries.

7. Have there been cases in which decision by fund managers to oppose or replace corporate management have adversely affected their standing with corporate clients?

Decisions by investment managers in voting on proxy matters in opposition to the current company management's wishes have undoubtedly adversely affected their standing and relationship with those corporate clients.

It should be pointed out, however, that there are similar types of conflicts occurring daily within the financial world. Every investment "buy" or "sell" recommendation or decision may well cause concern to the corporation whose stock is involved.

Again, investment managers are governed by ERISA and all their actions and decisions must be made with the interests of the ultimate beneficiaries in mind.

8. Should outside managers be barred from voting proxies of companies who are clients? If so, who should vote the shares?

While avoidance of any possibility of conflicts of interest among corporate management, financial advisors, and investment managers is to be desired, in the complex world of finance it is not always possible. It is understood that proxy

voting carries an element of fiduciary responsibility just as basic investment trading does. The investment manager may be in a difficult position, but he is obligated to vote the proxy in the best interests of the participants regardless of other considerations. If this is deemed to be a serious problem, the named fiduciary could always assume proxy voting responsibilities.

9. Are there specific pressures on fund managers associated with corporate takeovers?

There have undoubtedly been attempts by corporate managers engaged in takeover fights to apply pressure on fund managers. However, this pressure is not easy to apply and the success of any effort to apply pressure is far from assured. One reason why it is difficult to apply pressure is that fund managers are overwhelmingly interested in seeing that the funds under their management do well. To get a fund manager to do something that he thinks is not in the best interest of the funds he is managing is a very difficult thing to do and in our view, quite rare. Indeed, there are powerful practical disincentives for the manager to take such action: to the extent the fund's assets perform badly, his retention as fund manager is jeopardized.

10. How -- and how well -- do ERISA and the Department of Labor deal with conflicts of interest?

ERISA fiduciary principles clearly delineate the named fiduciary's responsibility in this area. The Department of Labor has, from time to time, provided guidance in this area

and generally it has been adequate. At this time, it is our strong view that while potential conflicts may arise, there is no evidence of a problem. The ERISA standards provide adequate safeguards and flexibility without dictating a result, such as forced delegation of proxy voting to a separate group or committee. We believe these matters should be worked out by the named fiduciary who will decide such matters in the exclusive interest of plan participants and beneficiaries.

11. Do current rules requiring the disclosure of holdings of individual companies provide adequate information? Who benefits from disclosure, and is it effective in limiting holdings of individual companies or industry sectors?

Current disclosure rules do provide adequate information. The main users of this information are corporations that get earlier notice of a possible takeover attempt than they would otherwise get. The disclosure rules are effective in limiting holdings in any one company, but are not effective in limiting industry holdings because a fund manager who wants to increase his holdings in an industry can buy stock in more companies in that industry.

12. How do large holdings of the stock of individual companies by pension funds or their outside managers affect trading activity?

Large block holdings increase the frequency of large block trades. The fact that many stocks are held in large blocks has caused some stock brokerage firms to develop the capability of trading large blocks. The fact that large blocks

of stock are now traded routinely is probably of no economic significance.

13. Should there be more explicit standards for asset diversification?

A well diversified portfolio that provides for balanced growth makes the most sense. The degree of aggressiveness in diversifying depends upon the objectives of the individual plan. In diversifying, the fund manager must take into account: (1) the plan's objectives, (2) the size of the fund, (3) financial and business conditions, and (4) the types of investments to be considered.

Pension fund management is a dynamic, continuous, and systematic process by which: (1) the plan's objectives, constraints, and preferences are identified and explicit investment policies are developed, (2) market conditions, relative values and sponsor circumstances are monitored, (3) strategies are developed and implemented through an allocation process, and (4) portfolio adjustments are made to reflect significant changes in any relevant variable to the process.

In the pension fund field there are many objectives. The fund sponsor would like to keep the funding cost down to help his earnings. The plan's objective is to enable benefits to be paid to retirees when due. The objective of the fund manager is to achieve at least the actuarial rate assumption while striving to maximize the expected return on the assets under management and at the same time adhere to specified risk constraints.

Portfolio objectives are normally defined in terms of minimum return objectives and a set of risk constraints. This focus is implicit in ERISA interpretations by the DOL which specify that a plan fiduciary must consider both the risk of loss and the opportunity for gain in determining whether or not a specific investment meets the objectives of a pension plan. Thus, the fund manager should strive to: (1) establish and maintain investment characteristics in terms of risk and minimum return requirements and (2) seek to obtain any incremental return above the minimum which can be captured without exceeding risk constraints.

The prudent man rule says the fiduciary "must act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matters would use in conducting an enterprise of like character and aim". This means the cost of purchase must not exceed the fair market value; there must be sufficient liquidity; and diversification of assets must be prudently made. In addition, section 404 provides that investments must be diversified so as to minimize the risk of loss unless clearly prudent not to do so.

The asset mix decision has emerged as the most important investment decision facing the plan sponsor. Its importance stems from the evidence that portfolios of securities within an asset class tend to react similarly to economic, social and political developments. Broad asset classes, however, such as stocks, bonds, short term

instruments, etc., are not as highly related to each other. Thus, the level of exposure to various asset classes largely determines the rate of return that will be earned.

14. Is the size of some funds a factor that constrains investment options?

The size of the fund is a factor. Some funds may be too small to participate in some investment options and thus are limited to the more traditional investments, i.e., stocks and bonds.

Participation in the full range of current investment options is limited to the largest of funds. Factors that constrain the fund include: (1) the size of the fund, (2) the liability structure, (3) objectives of the plan, (4) investment strategy, and (5) corporate policy.

15. Is it cost effective for the larger funds to invest in smaller or less established companies?

Investment in smaller or less established companies by the larger funds is not often measured in normal cost/benefit terms. Such investments carry the potential for partial or total loss of capital. However, the larger funds can take a much more aggressive investment posture over longer time periods. Generally, specific investments are small relative to the size of the total fund - thus, complete loss of principal would have little effect on the performance of the plan. On the other hand, these investments carry the potential far above average returns while providing valuable insight into new or emerging technologies.

16. Should funds of a given size be required to diversify management responsibility?

When pension funds are small, the assets are generally managed by one or two professional investment managers operating under guidelines set by the plan sponsor. As funds grow larger, diversification is achieved by adding managers and/or giving more assets to the existing managers. Eventually, however, the fund reaches such a size that to continue to add managers or to increase portfolio size may be counterproductive to the achievement of the plan's objective. At this time the decision to begin in-house management of some portion of the funds assets is often made. While this may appear to be a consolidation of assets under one manager, the assets can be invested in more than one asset class than assuming diversification.

The large fund thus is no different than other large investment management groups who successfully manage money under a variety of manager styles for a variety of clients.

In conclusion, we'd like to emphasize that in our view, ERISA is working. The manner in which plans invest and manage assets is unique to each plan, and ultimately, the plan sponsor is in the best position to ensure that decisions are made in accordance with the requirements of ERISA so that pension promises are most effectively fulfilled. Regardless of their place in the securities market, benefit plans are simply investors in American companies; they should not be driven to assume the role of management when they neither seek such a role, nor feel competent in it.

Mr. LUKEN. Thank you.
Professor Frankel.

STATEMENT OF TAMAR FRANKEL

Ms. FRANKEL. I am Tamar Frankel, professor of law at Boston University Law School, and I am very grateful for an opportunity to express my views on the role that fiduciaries, and especially pension fund managers, play in the securities markets, and in corporate governance. I will enumerate in this presentation a number of proposals which resulted from the examination of the issues presented here. These proposals are discussed in more detail in my written statement.

First, I propose that the Department of Labor be requested to clarify the status of pension fund investments in companies whose shares do not trade on the large exchanges and investments in real estate. In connection with this clarification, pension managing fiduciaries might be reminded that the choice of a particular manager, an expert in a particular type of investment, may predetermine the medium of the investment of fund assets.

If you ask somebody who is an expert in securities to manage an account, he will invest in securities and not in real estate. The clarification and the reminder may, hopefully, influence managing fiduciaries to diversify into markets other than large exchanges, thus reducing both the possible effect of those markets on pensions, and the pressure of pension funds' demand for financial instruments in the particular markets. The benefits would go both ways. Pensions would diversify the markets in which they deal to reduce their risks. The benefits would go both ways.

Second, pension funds should be notified that they may choose various forms of voting arrangements within the parameters of ERISA such as passthrough to participants. In small plans passthrough may work. Another voting arrangement is the appointment of voting committees. In larger plans, but not very large plans, that may work. A third arrangement is the appointment of an agent voting fiduciary. In some cases this form may be advisable. So we should try to find various voting process rather than just process.

Third, managing fiduciaries who exercise voting power should maintain and follow consistently policies with respect to votes on extraordinary proposals such as defensive tactics and on shareholder proposals. Such policies and adherence to them may provide managing fiduciaries with a partial safe harbor against claims of conflicts of interest, and helps render fiduciaries accountable.

The fourth and the fifth proposals are really intertwined. If managing fiduciaries of funds of a fairly large minimal size are vested with power to vote portfolio shares and these fiduciaries have conflicts of interest, they need not be barred from exercising voting power. However, they should notify the Department of Labor, first, of their voting; second, the nature of the conflict and, third, of the internal procedures involved in the voting.

Such notification can be short and not very costly. Such notification should be accorded confidential treatment and the Department of Labor would then be able to focus on these large pension manag-

ing fiduciaries and the circumstances of the voting. That is one side of the equation.

The other is the fifth proposal, that a provision should be added to an appropriate statute making it unlawful for issuers—or raider investors, as I call them—or their representatives, to browbeat—and I am using kind of very broad language here—by threats or promises, any fiduciary with respect to voting shares in its fiduciary capacity.

The enforcement of such a prohibition should be reserved to the Department of Labor. The purpose is to refocus on those who produce the pressure because I do not believe—although I have no empirical data—that the fiduciary managers are actively seeking to violate their duties. I think they are pressed into doing so.

The effect of the combined proposals would be to facilitate the supervision of managing fiduciaries voting by the Department of Labor and at the same time to reduce the conflict-of-interest pressures on such fiduciaries.

Obviously, my proposals are very general and require much further development and careful drafting. I think they may be worth a try. Thank you very much.

[The prepared statement of Ms. Frankel follows:]

Statement of Tamar Frankel
Professor of Law, Boston University.
March 19,1986.

Chairman Wirth and Members of the Subcommittee:

I appreciate the opportunity to express my views on issues which I consider very important and complex, namely the role of fiduciaries, and especially pension funds managers, in the securities markets and corporate governance.

a. Impact on the markets.

Pools of investments, especially pension funds have increased the demand for securities and the activity in the securities markets; they may continue to do so (so long as current tax laws remain unchanged). Most pension fund invest in financial instruments, either bonds or equity securities. This trend continues even though in my opinion ERISA allows pension funds to invest in the less liquid and less efficient markets, in which the stock of small companies and real estate are traded. [1] To reduce the pressure on stock exchanges and enhance pension fund diversification, the standards of prudence in ERISA should be clarified to state that pension funds may invest in less efficient securities markets and in real estate. I believe that such investments are appropriate for pension funds.

In addition, managers of pension funds may be alerted to the fact that by choosing investment advisers they determine the medium of their investment in advance. Securities managers invest in securities, not in venture capital companies or in real estate. Nonetheless, I do not believe that the standards of diversification should be made more explicit. Optimal diversification can not be determined by simple formula and may depend on the policies and needs of particular funds. Clarification of standards and suggestions as to the type of managers may be sufficient to induce pension funds to diversify by investing in smaller companies' stocks and real estate. In this fashion the impact of pension funds on the securities markets may be reduced.

b. Corporate Governance.

Managing fiduciaries should play a major role in corporate governance. There is a need for private monitors of corporate managements. Since the large corporations in the United States

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[1] Pension funds are engaged in long term investments similar to those of insurance companies. Investments in other than stock exchange markets may provide them with added diversification. If it is unclear whether pension funds may invest in real estate I would urge the Labor Department to clarify this point.

hold vast economic and political power, it is important that corporate managements not have unfettered discretion. They must be accountable. Corporate managements are made accountable through the courts, [2] and through a political process of election by shareholders. These shareholders include owners in a fiduciary capacity. The focus of this testimony is on the political process and especially on the votes by managing fiduciaries.

Managing fiduciaries have appeared with the process of pooling, which has been developing in the United States for decades. Pooling enables investors to obtain expert management, diversify their small holdings and benefit from economies of scale with respect to costs of management. The pooling process has been accelerating through mutual funds and deferred compensation or saving funds ("pension funds"). Pension funds are growing by more than 10% a year, and most of their investments are currently in the stock and bond markets. Thus, the managers of these pools have an enormous impact on the allocation and the form of capital (whether equity or debt, for example). Mutual funds, though much smaller, have also grown dramatically. A third pool of few but large investors has recently developed, headed by raider-investors. They too manage substantial amounts of other peoples money.

Pooling results in the creation of economic power centers that provide checks and balances to other power centers. Thus, the managements of large corporations provide a check to large shareholders, whether passive pension funds or active raider-investors, and vice versa.

To the extent that these power groups monitor and check each others' expansion, they provide checks and balances of each other's economic power. To that end, all groups should be allowed to develop and none should be permitted to overcome the other.

Today, the securities markets are populated by fiduciaries, and will increasingly be so populated. The problems involving the securities markets will therefore be somewhat different than those in the past. Whereas the main issues of the past involved information and education of unsophisticated investors, current issues involve the regulation of expert managing fiduciaries, be they corporate managers, pension fund and other institutional managers or raider-investors.

Does the voting of proxies for stock owned by pension plans play a significant role in corporate governance?

There is no doubt that the voting of stock owned by pension funds plays a significant role in corporate governance. However, not all the stock that pension funds own is voted by its trustees.

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[2] See for example, the ALI project on Corporate Governance, and the arguments concerning the degree to which the courts should control managements' business decisions.

Trustees may be directed trustees, having no investment or voting powers. A number of fiduciaries have passed their voting powers through to the participants or to voting committees. Trustee ownership per se does not mean power to vote. Therefore, before the impact of the fiduciaries on corporate governance is assessed, a study of the various capacities in which they own shares should be made. Nonetheless, we may assume that fiduciaries have substantial voting power, although not as large as their share ownership might indicate.

Do plan managers take an active interest in the management of companies whose shares they control?

Although I have no empirical data, I believe that fiduciaries have always evaluated the managements of portfolio companies both before buying the shares and during the holding period, even though 20 years ago the pressures on fiduciaries to perform were lighter than they are today. With increased emphasis on performance, fiduciaries' scrutiny of corporate management has increased. In the past, fiduciaries exerted influence on management informally, similar to the way large passive shareholders influence managements. When they became disillusioned with corporate performance, fiduciaries sold their shares rather than remove management, because this route was cheaper. Yet even the sale had a deterrent effect on management because of the adverse effect it had on the corporation's ability to raise capital. The sale signaled the displeasure of the fiduciaries to the markets.

With the emergence of shareholder proposals, fiduciaries were forced to choose between support and rejection of managements' position in a formal vote. This involvement increased with proposals for defensive mechanisms against take-overs which could reduce the value of the shares without compensation. On the other hand, fiduciaries were under increased pressure from the issuers with whom the fiduciaries had underwriting, advisory or commercial relations. Thus, both conflicts of interest and the visibility of the fiduciaries' actions increased.

c. Who should vote pension fund portfolio securities?

I suggest the following criteria for choosing the ideal voter: We wish to avoid government interference in the direction and control of corporate enterprises. We prefer that markets and private regulators make economic decisions. Therefore, owners of securities are preferable to fiduciaries, which must be regulated to some extent by the law.

The ideal private regulator or voter is someone who is personally affected by the risks and benefits from the investment. We believe that self interested judgment will result in the best choices for the investors, their enterprise and the country. We also look for voters who are interested in disciplining corporate management; voters who act not merely as short term investors for

short term profits, but also as long term investors, who would change the management rather than sell their shares when dissatisfied.

Also, we seek sophisticated voters, able to monitor corporate management and exercise good business judgment in voting. Finally, we would like private regulators whose voting will involve the least cost.

d. Should pension fund beneficiaries have some role in voting shares ---- in all cases and types of plans, in some, or none?

Under the criteria described above, the answer to this question depends on how much the voting would cost; on who bears the investment risk; and on who is the most qualified to evaluate the issue on which they vote. In large plans the costs of voting by participants are prohibitive, assuming for example 50 cents per participant. Let us assume that in total there are 15 million pension plan participants and about 300 portfolio issuers. At that rate, the cost of pass-through voting would be close to 4.5 billion dollars annually.

Second, the right of defined benefit plan participants to vote portfolio shares is not very clear to me. Since the shares resemble reserves for annuities that the plan issues to retiring employees, I am not sure that the participants bear the full investment risk, and therefore are entitled to vote the shares.

Finally, many plan participants are neither interested nor qualified to evaluate the complex financial statements and issues of take over and other structural changes put to the shareholders for their determination.

On the other hand, if the participants are especially interested in voting, there is no reason to prohibit them from doing so. Thus, I recommend leaving voting arrangements to the parties. Plan managers should be relieved of their fiduciary duties if the plan participants exercise the vote, free of coercion.

In some plans participants elect their voting representatives. This method was not uniformly successful. Problems involved such questions as who will provide the proposed representative and to whom will the representatives be accountable, in light of the usual passivity of the plan participants?

e. How do managing fiduciaries fit the ideal voter?

On the positive side, managing fiduciaries are sophisticated. They can judge the impact of management's proposals and evaluate managements' performance.

On the negative side, pooled voting means concentration of power. Such concentration may be necessary in light of the power concentrated in the hands of managers and raider-investors. In

addition, as mentioned before, the extent to which managing fiduciaries possess voting power is not clear.

Further, voting often poses conflicts of interest for managing fiduciaries. Other clients may be adversely affected by the vote that managing fiduciaries must cast. The more crucial the votes are for these clients, the greater the pressures that managing fiduciaries experience and the conflicts that they face. Finally, the evaluative function of managing fiduciaries is inhibited by absence of clear standards.

I conclude that notwithstanding conflicts of interest managing fiduciaries are the best voters, unless the parties make other arrangements. Therefore, managing fiduciaries should not be barred from voting proxies of companies who are their clients. Barring a fiduciary from an activity is an extreme remedy. Disclosure may be more appropriate in this case.

Conflicts of interest are reduced by the fiduciaries' own bias which militates towards economic performance on which their professional reputation and fees depend. Further, the alternatives to fiduciary voting are costly, and not always satisfactory.

In addition, managing fiduciaries are and should be regulated. The regulation of fiduciaries requires a delicate balance, between leaving sufficient discretion to the fiduciaries and avoiding government interference in economic decision making, on the one hand, and imposing sufficient constraints on fiduciaries to make them accountable for their actions, on the other hand.

The courts have attempted to achieve this balance by a complex set of rules, which can be very generally described as follows: First, the greater the conflicts of interest, the greater the judicial or agency scrutiny of the fiduciaries will be. Therefore, if the pension fund managers are also officers and directors of the issuer, their dealing with the issuer's shares will be subject to substantial scrutiny.

Second, the greater the economic benefits which the managing fiduciaries reject, or the risk which they undertake for the fund, the greater the scrutiny which their decision would undergo. Therefore, the higher the premium at which a tender offer is made, the greater will be the scrutiny of a decision to reject the offer. The same premium may therefore lead to different results. Rejection of an offer by an independent manager may be acceptable whereas the rejection of the same offer by managing fiduciaries tainted with conflict of interest will be scrutinized and perhaps overruled.

Scrutiny amounts in most cases to a burden on the managing fiduciaries to justify their decisions. Those with conflicts of interest may decide to resign and appoint others, free of conflict, to make the decision. Or they may make the decision after informed deliberation and support by independent experts. Or

they may simply make the decision. In the latter case there is a high degree of probability that their decision will prove faulty and they will be found liable.

As to conflicts of interests I suggest two actions. First, managers should be required to prepare and follow consistently a written policy with respect to voting on extraordinary proposals such as shareholder proposals, defensive tactics and mergers and other structural changes.

Second, I believe that the law should specifically make it unlawful for issuers raider-investors and their representatives to brow beat (by threats or promises) fiduciaries in connection with voting portfolio shares. Such pressure is impermissible under current law because it induces fiduciaries to breach their duties, but since no one has the interest in preventing the violations the law is rarely enforced. A statutory prohibition could be enforced by the Department of Labor.

It might be desirable to require large plans, in which the decision is not made by the participants, to report the cases in which managing fiduciaries have conflicts of interest because they have an interest in the issuer as its directors and officers or as its adviser or underwriter or lender. Reports on whether conflicts exist and on whether independent experts or substitute fiduciaries were used, will also be helpful. These reports should be confidential, and only the Department of Labor should have the power to enforce the reporting requirement.

From the point of view of the Department it is almost impossible to monitor all the tender offers and votes of all pension funds. However, if the Department disregarded small plans, plans in which the decision is made by the participants, and plans in which the managers have little or no conflicts of interest, the Department could use its resources to focus on the largest plans with most conflicts of interest and scrutinize their decisions.
The proposed reports will assist the Department of Labor to channel its resources to the more sensitive and largest possible violations.

As to specific standards to guide fiduciaries in voting proxies, I believe that clarification is in order. Currently, it is unclear whether managers can take into consideration the future of the corporation and the social implications of take-overs. The ERISA provision requiring fiduciaries to manage the plan "solely" in the interests of the participants is vague. Since every transaction beneficial to the plan may benefit others. [3] The word "solely" must be aimed at the managers' decision process rather than the resulting benefits from the transactions. Some commentators argued that in making an investment or voting decision fiduciaries may not consider benefits to others.

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[3] For xample, a sale of stock will benefit the buyer, or he would not be willing to pay.

Other commentators argued that ERISA prohibits consideration of benefits to others only when these benefits trickle down to the fiduciaries. Under this interpretation the word "solely" merely prohibits indirect conflicts of interest.

I suggest that the term should be clarified especially with respect to voting, to permit fiduciaries to take into account future plans for the company both by its managements, and by raider-investors and the probable effect of those plans on the long term and short term value of the shares.

This interpretation, vesting in managing fiduciaries broad discretion in areas that involve subjective values, and which are not amenable to standards, leaves them substantial freedom from accountability. However, fiduciaries are highly qualified to make economic judgments and weigh them against political considerations. Their own bias militates towards economic performance on which their professional reputation and fees depend. Because there is less danger that professional fiduciaries will ignore the economic impact of their votes, they may be granted greater discretion in voting portfolio shares. However, similar discretion should not be allowed to plan sponsors or unions.

To avoid government interference with the actual voting standards, and yet render fiduciaries accountable, the standard in ERISA might be clarified. A standard similar to that of the business judgment rule should perhaps serve the purposes, provided that the voting fiduciaries have no conflicts of interest with the participants or the funds themselves. Absence of conflicts must be clear. The law can provide a strict standard for such a fiduciary.[4]

f. A New Voting Trustee.

An option, which may appeal to many plans is the creation of a new voting fiduciary, an agent with revocable powers. If, for example, the Department of Labor permitted plan fiduciaries to delegate voting power to others, who will be fiduciaries under ERISA, a number of our objectives might be achieved.

First, power will be further dispersed. Second, the Department of Labor may ensure that voting fiduciaries possess minimal competence. In addition, voting fiduciaries should follow a process of deliberating and studying the issues on which they vote. If the fiduciaries satisfy these two requirements, it might be safe to permit them to vote in accordance with their business judgment, which will then not be subject to judicial or administrative review.

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[4] For example, such a voting fiduciary should be barred for a number of years, say three, from obtaining any other position with any company whose shares it votes.

Where will the talent required to evaluate proxies and vote be found? After all, the persons suitable for the position are all likely to be engaged in more lucrative businesses. Perhaps these voting trustees will emerge from the accounting and legal professions, and occupy a position, similar to the position of appraisers which the Department of Labor has permitted and required to serve in a number of its conflicts of interest exemptions. Fees provide an incentive to serve as voting fiduciary while concern for liability resulting from conflicts of interest may provide managing fiduciaries an incentive to appoint such voting fiduciaries and pay their fees.

This option is not the only way in which pooled shares should be voted. It is merely an additional option. It satisfies three of our criteria: diversity of voters, informed voters and minimal government intervention. If the parties to the pension fund choose other voting arrangements, they should be allowed to do so. The law should not impose specific arrangements on them, but encourage the parties to design the voting arrangement that suits them.

Mr. LUKEN. Thank you very much, Professor Frankel.
Mr. Heard.

STATEMENT OF JAMES E. HEARD

Mr. HEARD. Thank you, Mr. Chairman. I am James E. Heard, deputy director of Investors Responsibility Research Center. IRRC has about 250 clients, among them many of the Nation's largest institutional investors. Most of what I am going to say today has to do with the voting policies and practices of investment managers for private pension funds.

Whether hostile takeovers are in the public interest is, of course, a hotly debated question, as the subcommittee well knows. It is understandable that corporate executives who fear hostile raids wish to protect themselves as best they can. And while it is possible to argue that some antitakeover measures, such as fair-price requirements, benefit shareholder by encouraging would-be acquirers to negotiate directly with management, measures that make it all but impossible to change control cannot possibly be said to be in shareholders' interest.

This is well understood by investment managers. Indeed, I have never met a reputable investment manager who believes that he is fulfilling his fiduciary responsibilities by supporting the adoption of measures that disenfranchise stockholders.

Most major pension plans subject to ERISA retain outside investment managers to manage their funds, as do many public sector funds. In most instances, voting decisions are delegated to the investment manager as part of the investment responsibility. It is, therefore, the major banks, insurance companies, and investment firms that are making most of the voting decisions on antitakeover measures for funds subject to ERISA. And of course, they also manage billions of dollars in other accounts for which they have similar fiduciary responsibilities.

As part of our efforts to keep clients informed on corporate governance matters, we obtain voting results on these questions every year. We also survey our own clients and other institutions each year to determine their voting policies and practices. With few exceptions, the participants in these surveys have insisted that we not identify them by name, and, so, we are not free to identify respondents. But we can say that the participants have included many of the largest investment firms, bank trust departments, and insurance companies in the country.

Let me give you a few of the highlights of our recent survey published in October 1985.

Most of the antitakeover measures being voted on are being adopted. More than 95 percent of the 450 or so proposals presented to the 250 of so companies for which we obtained voting results last year were adopted.

Although the level of opposition is noteworthy in some cases and although levels of opposition were actually higher in 1985 in some cases than in previous years, the levels of opposition are surprisingly low, given the high levels of institutional holdings of many of the companies involved.

Some institutions that previously opposed antitakeover measures are now making more exceptions and supporting them, and some have changed their policies from opposition to support.

Many institutions also report that there were more inquiries in 1985, and even more pressure, than ever before from companies wanting to know how the institutions involved intended to vote on specific issues.

While many institutions continue to vote independently, these results suggest that a significant number of institutions are voting to approve measures that are contrary to shareholders' interests so as not to offend existing or potential clients.

This impression has been strengthened in a number of instances where we have been told privately that individual votes or voting policies have been changed as a result of either direct pressure from companies or because of fears that existing clients will be offended. It is difficult to see how this kind of activity can be squared with their fiduciary responsibilities that investment managers have under ERISA, other statutes, or common law.

Potential conflict-of-interest problems are most common among banks and insurance companies, which often have a multiplicity of relationships with corporate clients. The fact that pension fund managers face potential conflicts of interest in connection with voting decisions is, of course, nothing new. The wish not to offend clients gave rise to the traditional Wall Street rule in the first place and, not surprisingly, it continues to be a concern of investment managers.

The fact that so few investment managers are willing to speak publicly about these matters suggests one of two things. Either there is not any problem, or it is something people would rather not talk about in the hope that the problem will go unnoticed.

Having studied the issues for a number of years now and talked to many people in the investment community who are very well informed, it seems quite clear to me that many pension fund managers are shirking their fiduciary responsibilities. There is no other conclusion that one can come to after examining the voting results for the last several years. Exactly how many fund managers are involved is unclear, for fund managers can hardly be expected to brag openly about their behavior.

This behavior is economically harmful.

Mr. LUKEN. In order to be fair, you are about out of time.

Mr. HEARD. I will be finished in 30 seconds. This behavior is economically harmful to pension plan participants. It is also unlawful. The unwillingness or inability of the Labor Department to do anything about these conflict-of-interest problems fuels the perception that the Department is a shuteyed sentry. The steady erosion of shareholder rights makes management less accountable, and the ability of shareholders to participate meaningfully in the corporate government process is being diminished. If left unchecked, this erosion of shareholder rights will eventually undermine the legitimacy of our corporate governance system.

Thank you very much.

[The prepared statement of Mr. Heard follows:]

TESTIMONY BY

JAMES E. HEARD

Chairman Wirth and members of the subcommittee, my name is James E. Heard. I appreciate your invitation to testify and hope that my testimony will be helpful to the subcommittee. The chairman, members of the subcommittee and the staff are to be commended for the very thorough, fair and professional job all of you have done over the past two years in reviewing the issues raised by hostile takeover attempts. While there remain many unanswered questions, and certainly many disagreements over what, if anything, ought to be done about hostile takeovers, everyone involved in the debate can feel that this subcommittee has sought and received a wide range of advice.

Many of the issues on your agenda today are in some way related to hostile takeovers. More fundamentally, though, the issues arise as a result of the institutionalization of our capital markets, and particularly the phenomenonal growth in the holdings of public and private pension plans.

Drawing on my experience as deputy director of the Investor Responsibility Research Center, and as director of its Corporate Governance Service, I would like to comment on several of the issues that you have asked witnesses to address today.

I wish to emphasize that I am testifying on my own behalf today and not as a representative of the Investor Responsibility Research Center. It may, however, be helpful to describe briefly the nature of the organization's work.

The Investor Responsibility Research Center is a not-for-profit corporation established in 1972 to provide impartial reporting and analysis of policy questions for institutional investors. It has a diverse clientele of nearly 250 institutions, among them major colleges and universities, public pension funds,

bank trust departments, insurance companies and investment firms. Its clients include some of the largest pension fund managers and many of the largest public pension funds in the country.

IRRC does not make recommendations to its clients; its research is intended to give them an informed basis for making their own decisions. Current research covers three broad areas: social and ethical questions that come to votes in the form of shareholder resolutions at annual meetings of major corporations; business activities of U.S. companies in South Africa and the issues that this involvement raises for institutional investors; and corporate governance questions that affect the rights of shareholders and the value of their investments.

The focus of my testimony today is on the effects that the growth in pension fund assets is having on our system of corporate governance.

Public and private pension funds are now estimated to have more than a trillion dollars in assets, much of it managed by major banks, insurance companies and investment firms. These institutions dominate trading in our securities markets. By some estimates they own as much as 30 percent of the stock in our publicly held corporations. Among larger companies the level of institutional ownership is even higher. According to the most recent Standard & Poor's, for example, pension funds and other institutional investors own 64 percent of American Cyanamid, 72 percent of Bausch & Lomb, 72 percent of CBS, 67 percent of Data General, 68 percent of Deere & Co., 49 percent of General Electric, 64 percent of General Mills, 53 percent of Georgia Pacific, 66 percent of Goodyear, 52 percent of Household International, 50 percent of IBM, 61 percent of Johnson & Johnson, 70 percent of Eli Lilly, 57 percent of Martin Marietta, 64 percent of Monsanto, 60 percent of Owens-Corning Fiberglas, 59 percent of Pfizer, 57 per-

cent of Scott Paper, 69 percent of TRW, 68 percent of Travelers, 75 percent of UAL (holding company for United Airlines), 61 percent of Warner-Lambert and 69 percent of Whirlpool.

Obviously, holdings of this size put major institutional investors in a position to exercise significant influence in corporate decision-making.

Traditionally, financial intermediaries such as bank trust departments and insurance companies have taken a passive role in the corporate governance process. Most have followed the so-called "Wall Street Rule" of supporting the managements of companies in which they hold stock when issues are put to shareholders for their approval.

It may have been possible to justify this practice in the past, when institutional holdings were much smaller and when voting questions were largely inconsequential. But today, the size of institutional holdings, the existence of federal fiduciary standards imposed by ERISA (the Employee Retirement Income Security Act) and the nature of the voting issues which investors are being forced to confront require pension fund fidcudiaries to adhere to higher standards of conduct.

The hostile takeover phenomenon of the 1980s has led many companies to adopt antitakeover charter amendments to discourage takeover attempts opposed by incumbent managements and their boards of directors. During the first nine months of 1985 we identified more than 250 companies, including many of the nation's largest, that asked shareholders to approve antitakeover measures at annual or special meetings. We have recently completed a tabulation of antitakeover measures adopted by S&P 500 companies, and the results of this tabulation indicate a

dramatic increase in the number of companies that have added antitakeover measures to their charters.

To cite just a few figures from our analysis:

- 146 of the S&P 500 companies now have fair price provisions in their charters, compared with only 85 in late 1984;
- more than 200 now have classified boards of directors, and almost as many limit the rights of shareholders to amend the bylaws or call special meetings of shareholders;
- more than 300 now have the authority to issue blank-check preferred stock, which can be used to create poison pills;
- more than 40 S&P 500 companies now have poison pills, compared with only four in late 1984, and the number is growing every day.

Whether hostile takeovers are in the public interest is, of course, a hotly debated question. And it is understandable that corporate executives who fear hostile raids wish to protect themselves as best they can. It is clear, however, that the adoption of measures that transfer rights from shareholders to managers and directors and deprive shareholders of opportunities to consider transactions that are almost certain to reward shareholders are measures that are contrary to shareholders' interests. While it is possible to argue that some antitakeover measures, such as fair price requirements, benefit shareholders by encouraging would-be acquirers to negotiate directly with management, measures that make it all but impossible to change control cannot possibly be said to be in shareholders' interests. This is well understood by investment managers; indeed, I have never met a reputable investment manager who believes that he is fulfilling his fiduciary responsibilities by supporting the adoption of measures that disenfranchise stockholders.

Most major pension funds subject to ERISA retain outside investment managers to manage their funds, as do many public sector funds. In most instances, voting decisions are delegated to the investment manager as part of the investment responsibility. It is, therefore, the major banks, insurance companies and investment firms that are making most of the voting decisions on antitakeover measures for funds subject to ERISA, and of course, they also manage billions of dollars in other accounts for which they have similar fiduciary responsibilities.

As part of its effort to keep clients informed on antitakeover issues, IRRC obtains voting results on antitakeover measures for as many companies as we can identify. We also survey our own clients and other institutions each year to determine their voting policies and practices. With few exceptions, the participants in these surveys have insisted that we not identify them by name. We are not, therefore, free to identify respondents, but we can say that participants have included many of the largest investment firms, bank trust departments and insurance companies in the country.

To summarize the results of our most recent survey, published in October 1985:

- Most of the antitakeover measures being proposed are passing. More than 95 percent of the proposals for which we obtained results last year were adopted.
- Although the level of opposition is noteworthy in many cases, and although levels of opposition were actually higher in some cases last year than before, levels of opposition are surprisingly low given the high levels of institutional holdings at many of the companies involved.
- Some institutions that previously opposed antitakeover measures are now making more exceptions and supporting them, and some have changed their policies from opposition to support.

- Many institutions reported that there were more inquiries in 1985 than ever before from companies wanting to know how the institutions involved intended to vote on specific issues.

While many institutions continue to vote independently, these results suggest that a significant number of institutions are voting to approve measures that are contrary to shareholders' interests so as not to offend existing or potential clients. This impression has been strengthened in several instances where we have been told privately that individual votes, or voting policies, have been changed as a result either of inquiries from companies or because of fears that an existing client will be offended.

It is difficult to see how this kind of activity can be squared with the fiduciary responsibilities that investment managers have under ERISA, other statutes or common law.

Potential conflict-of-interest problems are most common among banks and insurance companies, which often have a multiplicity of relationships with corporate clients. Overlapping memberships on boards of directors add yet another dimension to the likelihood that conflicts may arise which may force banks and insurance companies to choose between fiduciary responsibilities and business relationships.

The fact that pension fund managers face potential conflicts of interest in connection with voting decisions is, of course, nothing new. A wish not to offend clients is one factor that gave rise to the traditional Wall Street Rule in the first place, and not surprisingly it continues to be a concern of investment managers. As Roger F. Murray, emeritus professor of finance at Columbia Univer-

sity and a respected adviser to many financial institutions, noted some time ago, "The investment manager retains his clients and earns his fees by delivering good performance, which is measured against market indexes at frequent intervals. No plan sponsor adds to the performance measure points for thoughtful consideration of corporate governance issues. On the other hand, voting portfolio shares against the antitakeover proposals of a present or prospective client is seldom perceived as the best way to cement or create a warm relationship."

There are, in addition, numerous other instances in which conflict-of-interest problems can arise. The use of pension fund assets in contests for corporate control presents especially troublesome conflict-of-interest problems for pension plan sponsors, plan trustees and outside managers. Plan sponsors and trustees named by management may be tempted to use plan assets either to acquire the assets of other companies or to defend against hostile takeover attempts in ways that are contrary to the interests of plan participants. Banks serving as trustees for employee savings plans may find that their fiduciary obligations to plan participants put them into conflict with valued commercial clients whose managements become targets of hostile takeover attempts. We know very little about what may actually have transpired in such instances, but the potential for conflict of interest are clearly present.

The fact that so few members of the investment community are willing to speak publicly about these matters suggests one of two things: either there isn't any problem, or it's something people would rather not talk about in hopes that the problem will go unnoticed. Having studied the issues for a number of years now and talked with a fair number of well-informed people, it seems quite clear to me that many pension fund managers are shirking their fiduciary responsibilities. Exactly how many remains unclear; fund managers can hardly be ex-

pected to brag openly about their behavior, but it is difficult to look at the voting results on antitakeover measures and not come away with the conclusion that large numbers of institutions are involved.

There are several reasons why these developments are a cause for concern. First, they are harmful to the interests of plan participants. Common sense alone is sufficent to indicate that denying shareholders--i.e., pension plan participants--the opportunity to participate in transactions that are likely to increase the value of their shares is economically harmful to them. Our own research and that conducted by the Securities and Exchange Commission provide empirical support for this conclusion.

Second, the inability or unwillingness of the Department of Labor to do anything about these conflict-of-interest problems undermines the credibility and effectiveness of its administration and enforcement of ERISA. Inaction fuels the perception that the Department is a shut-eyed sentry.

Third, and perhaps most importantly, the steady erosion of shareholders' rights threatens to undermine the legitimacy of our system of corporate governance. The adoption of antitakeover charter amendments, poison pills and voting plans that disenfranchise public stockholders is creating a corporate governance system less and less able to function as it should. The ability of shareholders to participate meaningfully in the governance system is being diminished. This development is being accelerated by some of the very institutions that should be seeking to reverse it. It is an unfortunate irony to see both the New York Stock Exchange and the Securities and Exchange Commission pursuing laissez faire policies on shareholders' rights that are premised on the assumption that institutional investors are becoming a stronger force for accountability, when in

fact precisely the opposite seems to be occurring. If left unchecked, this erosion of shareholder rights will lead eventually to a situation in which many will ask whether there is a need for new and different accountability mechanisms.

An obvious question is what should be done about the problem? First, we need to know more than we do. These hearings are a good start, but we need to have a better understanding than we do of the respective roles that plan sponsors and their outside managers play in the corporate governance process. Little is known, for example, about the role of plan sponsors, and a broader information base regarding the activities of fund managers is needed.

Second, the Labor Department needs to be encouraged to pay more attention to these issues. It needs to speak publicly about the problems of conflict of interest, it needs to improve its reporting system in ways that give it more information about what it going on, and it needs to take some highly visible enforcement actions. This is a considerable challenge, given the meager resources that the ERISA program now has and the budget constraints that it faces. But without better administration and enforcement it is unlikely that there will be any significant change in behavior of those subject to ERISA. The long-term goal ought to be to put administration and enforcement of ERISA on a par with administration and enforcement of the federal securities laws. Whatever its shortcomings, the SEC overall does an outstanding job of administering and enforcing the federal securities laws, and it provides a model of what we ought to be trying to do with ERISA. Given the size and the importance of private pensions in our economy today, we ought to be providing a level of oversight on pensions comparable to what we have in the securities area.

Third, attention needs to be given to other proposals to strengthen our system of corporate governance and to protect the rights of pension fund participants. One suggestion is that plan sponsors or plan participants should make voting decisions that are now delegated to outside managers. The attraction of the idea is that it puts decision-making in the hands of those whose interests are most directly at stake and relieves investment managers of the unwelcome task of offending their own clients. While this may work in some cases, a number of problems are likely to arise in other instances. Investment managers are usually much better informed than plan sponsors and plan participants and are better able to appreciate the investment implications of various actions; plan sponsors may lack the resources to become better informed; plan participants may have little or no interest in being involved; and plan sponsors may face conflict-of-interest problems that are as potentially disabling as those faced by outside managers.

Regardless of what actions are taken, two important and related objectives ought to be pursued in considering the role that pension funds play in the corporate governance process. One is to safeguard the interests of pension fund participants. The other is to ensure that we maintain a system of corporate governance that meets acceptable standards of accountability.

Mr. LUKEN. Thank you very much, Mr. Heard.

Mr. Monks.

STATEMENT OF ROBERT A.G. MONKS

Mr. MONKS. Thank you very much, Mr. Chairman. I would like to take a second to get close to the microphone and recover from being referred to as a "shuteyed sentry." I was a former Administrator of the Pension Office of the U.S. Department of Labor.

Mr. LUKEN. What do you think of his rhetoric? You don't like the personal application? That woke a couple of people up.

Mr. MONKS. My eyes are open.

My name is Robert Monks. I am president of Institutional Shareholder Services, mentioned earlier. From 1983 to 1985 I served as Administrator of the Pension Office at the U.S. Department of Labor. My remarks will focus on the voting rights held by institutional investors, specifically how they are exercised and whether they have value.

To give a brief bit of background, private plan assets total over $1 trillion, and they own one-third of the publicly traded stock in U.S. corporations. That figure is projected to increase to one-half by the year 2000.

It is very common for large pension plan sponsors to delegate the management of these assets to money managers and banks, charging them with both investing and voting duties. Bear in mind that the law which governs private pension plans, the Employee Retirement Income Security Act, ERISA, requires that assets shall be managed for the exclusive benefit of plan participants. Assets include both material property and any voting rights attached thereto. Money managers and banks who receive delegation of these duties therefore serve as intermediate fiduciaries for the beneficiaries of pension plans. But the voting duty is unrelated to the main business of financial institutions. No firm is paid extra to exercise voting rights. No one has ever attracted new business on the basis of his superior voting record. And finally, as we have heard amply this morning, voting is time-consuming paperwork that carries with it unwelcome controversy and the potential of conflict of interest.

Consider then what this means about the governance of America's largest corporations. Voting control of large corporations rests with a small number of financial institutions. The institutions are subject to the single fiduciary law embodied in ERISA. It has been shown that companies that adopt antitakeover provisions diminish the value of their shares to those that own them.

The fact that antitakeover provisions are passing easily indicates that majority owners are voting for them, and by definition these include many institutional investors serving as fiduciaries.

This is not simply my equation, Mr. Chairman. At Senate hearings held last year on ERISA enforcement by the Senate Committee on Oversight of Government Management, one leading money manager noted that, "I think it is interesting that antitakeover charter provisions do seem to pass, even in companies which are widely held by institutions or fiduciaries * * * one has to assume

from this that there must be some [institutional] votes for those provisions * * *."

Institutional support for provisions that are clearly antithetical to shareholders' interests can be explained only by one fact: conflict of interest. It is large corporate clients who are responsible for the business of large financial institutions. It is also large corporations that are proposing antitakeover provisions, large corporations whose managers and directors are anxious to keep their jobs.

It is the same corporations who are pressuring financial institutions to vote in favor of antitakeover provisions and who might take their business elsewhere if they thought a money manager was voting against them. That is precisely what the law requires. The law stipulates that fiduciaries, whether the original plan sponsors or the delegates, shall vote shares according to the best interests of the beneficiaries, not the best interest of corporate managers. How can it be prudent for a fiduciary to vote for measures that he knows will reduce the values of the shares which he holds in trust?

There is ample evidence, Mr. Chairman, that pressure is applied to fiduciaries to vote with management on antitakeover provisions. There was also testimony before last year's Senate hearing indicating that such activities are taking place, in addition to the testimony you have already heard this morning, most particularly from Mr. Heard. As a result, votes are being cast in a way that not only diminishes shareholders' value but that precludes shareholders from having an effective voice in corporate governance decisions of any kind.

Consider the fact that more than 770 companies have now adopted antitakeover policies. Since the November 1985 *Household* decision in the Delaware Supreme Court, more than 80 corporations have adopted so-called poison pills. These are not inconsequential companies, these are the Fortune 500.

The shareholders of these companies not only find themselves owners of stock with reduced value, but in many cases antitakeover provisions make it next to impossible for shareholders to call special meetings, to remove directors, or even to approve or disapprove any measure without a super-majority vote of unattainable proportions. And the end result is that many large American corporations are effectively being locked out by current management and directors who have insulated themselves from any practical challenge by owners—I am sure, Mr. Chairman, a provision that many Members of this body would like to emulate.

This runs counter to the longstanding tradition of self-regulation——

Mr. LUKEN. You want to abolish November?

Mr. MONKS. This runs counter to the longstanding tradition of self-regulation by corporations based on managing directors being accountable to owners with multiple antitakeover policies. Today they are accountable only to themselves. And this is taking place with the knowledge and acquiescence of institutional owners who not only possess a controlling vote in corporate America but who have a fiduciary responsibility to protect the best interests of their beneficiaries.

Their abdication of this responsibility comes at a time when other self-regulatory mechanisms are weakening, a notable example being the New York Stock Exchange's proposal to end the one-share, one-vote listing requirement, about which you had hearings a year ago, Mr. Chairman.

History tells us that the concentration of economic power in an insulated body accountable to no one has coincided with commercial disaster. It would be regrettable to learn the 1920's lessons all over again.

There are several options for action. It is possible that the remedy is to prepare Federal legislation mandating voting responsibilities and standards. Although many feel that ERISA contains such a requirement, no one can deny that its impact has been modest to the point of nonexistence.

Ultimately, of course, the voting responsibility is the corporate plan sponsors' concern. If private companies do not involve themselves in guaranteeing that pension plan shares are voted "for the exclusive benefit of plan participants," there will be no alternative to Federal action.

Thank you, Mr. Chairman.

[Testimony resumes on p. 116.]

[The prepared statement of Mr. Monks follows:]

STATEMENT BY ROBERT A.G. MONKS

BEFORE THE HOUSE COMMITTEE ON ENERGY AND COMMERCE

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

MARCH 19, 1986

Mr. Chairman, thank you for the opportunity to testify today. My name is Robert Monks; I am president of Institutional Shareholder Services, Inc. From 1983-85, I served as Administrator of the Office of Pension and Welfare Benefit Programs at the U.S. Department of Labor.

This hearing will cover several issues regarding corporate governance. I will focus my statement on one of those issues -- the voting of shares held by ERISA and other trustees. My comments will address two aspects of the vote: how it is actually exercised, and whether it has any real value.

On the first subject, it is known that public and private pension plans own approximately one-third of publicly-traded

stock in U.S. corporations. That figure is projected to increase to one-half by the turn of the century. The Employee Retirement Income Security Act of 1974 (ERISA), which governs all private pension plans, stipulates that all plan assets shall be managed for the exclusive benefit of the plan's participants. Assets are defined as including both material property and any voting right attached thereto.

Although a private corporation is the primary fiduciary for its pension plans, it is common for large corporations to delegate both money management and the vote to an outside agent. That agent is most frequently a bank or a money manager. But consider several facts about delegation. The agent is paid nothing extra to vote the shares. Voting is a time-consuming paperwork that must be handled by employees who have ongoing portfolio management responsibilities. And most importantly, the intermediate fiduciary will often face serious conflicts of interest in trying to vote the shares of one client company that are held in the portfolio of another client. Consider the client who wishes to enact several anti-takeover provisions. He approaches a given money manager and expresses the hope that his company's shares held by that manager will be voted favorably. This may well not be in the best long-term interests of the other beneficiaries whose portfolios the manager handles. Yet he risks losing a large client if he opposes the anti-takeover amendments.

Are such conflicts occurring? They are. Is anyone doing anything about it? No. What are the consequences? The consequences are that corporate America is adopting governance provisions that would better be labeled "dictatorship" provisions, for they effectively deny shareholders access to any form of governance process. It must be asked what institutional investors -- who are the majority shareholders -- are doing about this problem. Don't they, as fiduciaries, have an obligation to protect their beneficiaries? If they fail to do so, will it fall to the government to take remedial action?

This brings me to my second point, Mr. Chairman. Public corporations were traditionally founded on the notion that directors and officers have a strict fiduciary obligation to protect the interests of shareholders. It is the shareholders whose rights are preeminent, and whose voice is decisive. To quote a recent court decision, "While the day-to-day affairs of a company are to be managed by its officers under the supervision of directors, decisions affecting a corporation's ultimate destiny are for the shareholders to make in accordance with democratic procedures."[1/]

[1/] Norlin v. Rooney, Pace, Inc., 744 F2d 255, 258 (2nd Cir. 1984).

The recent wave of takeovers, however, has strained the application of fiduciary obligation. Shareholders are interested in maximizing value, while corporate management is interested in continued employment. Confronted with the realities of hostile raiders who have taken on even the largest companies, managers and directors have responded quickly. Their responses, unfortunately, have had consequences far worse than the problem they attempt to solve. The anti-takeover provisions that have been, and are being, adopted constitute a fundamental change in the most basic element of American corporate governance -- the need for management to be accountable to shareholders. By law and tradition, the power vested in corporate officers and directors is legitimate because of their continuing responsibility to owners -- the shareholders. Elimination of the need to be responsible means that management now answers only to itself.

It is helpful to understand how anti-takeover provisions have effectively disenfranchised shareholders. Generally speaking, there are three kinds of anti-takeover provisions, those involving super-statutory majorities, so-called poison pills, and dual capitalization plans. Their permutations are as numerous as are lawyers' imaginations, and there is no need to go into a detailed discussion of them here. Their impact, however, is relatively simple: there can be no fundamental

change in the corporate governance system -- whether it is the calling of shareholders meetings, the legal means for shareholders to act, the percentage of shares necessary for a quorum, the number of directors or their removal, the merger or sale of a company -- without either a) the consent of the existing Board of Directors (or their appointed successors), or b) an extremely high percent of the outstanding shares, often a number that is often practically unobtainable.

Two recent examples of corporate governance changes will give a sense of the disease that is infecting corporate America.

A. The Potlatch Company

In July of 1985, Samuel Belzberg advised The Potlatch Company, a San Francisco-based timber products company, of the Belzbergs' substantial stockholdings in Potlatch and asked to meet with management. Potlatch management refused. On October 22, Potlatch announced that its Board had approved, and would propose to shareholders, a charter amendment to implement time-phased voting. Potlatch already had in place an array of anti-takeover measures, including a staggered Board of Directors; a fair price amendment providing for an 80% supermajority vote on transactions with holders of more than 5% of the shares, unless previously approved by the

Directors; a charter provision prohibiting action by consent of shareholders without a meeting, shareholders having no right under Delaware law or the Company's charter or by-laws to call a meeting; and a charter provisions prohibiting shareholders from altering or amending any by-laws except with the approval of the holders of at least 80% of the outstanding shares, the Directors having the power to alter or amend the by-laws themselves.

On November 1, First City Financial Corporation, a Belzberg-controlled entity, wrote to the Company expressing its opposition to the proposed time-phased voting amendment and stating that it was prepared to enter into an agreement providing for the acquisition of Potlatch for cash at a price of $45 per share. The offer letter stated: "If you enter into good faith negotiations with us, we believe that working together we can negotiate a substantially higher price for Potlatch stockholders." Management again refused to meet with Belzberg.

On Monday, November 11, at 8:49 a.m. Potlatch reported that its Board unanimously rejected the Belzberg offer, and announced a share repurchase program for up to 20% of its outstanding stock, or approximately 3.1 million shares. Potlatch stated that the interests of stockholders and other constituencies would be served best by the continued

independence of the Company, and that the purpose of the share repurchase program was to frustrate the Belzberg bid and "to facilitate the sale of shares by those stockholders who wish to sell at this time." Within one and one-quarter hours of the opening of the market, 1.1 million shares of Potlatch stock (including a block of 315,000 shares traded during the first 15 minutes) traded at prices up to 42 5/8. Potlatch purchased all of the Belzberg holdings -- 1,086,500 shares -- at $43 per share plus a reimbursement of nearly $1 million of expenses. The Company announced on Tuesday, November 12 that it had purchased a total of 2.4 million shares during the previous day (including the Belzberg holdings of 1.1 million shares). That day's total volume on the New York Stock Exchange was slightly less than 1.5 million shares. Thus, on Armistice Day, the Belzbergs and those able to react within one hour of publication of the press release were able to sell shares at an average of approximately $42.75 per share. The closing price on November 11 was $39.75; the opening price on November 12 (a late opening at 10:30 following public announcement at 9:57 of the previous day's repurchases) was $36.25.

Following the share repurchases, descendants of the founding families of the company and predecessor companies held approximately 51% of Potlatch's outstanding shares, and

an employee benefit plan of the Company held another approximately 6%.

Under Delaware law a charter amendment implementing time-phased voting requires the affirmative vote of (i) a majority of the Board of Directors, and (ii) the holders of a majority of the outstanding stock. In view of the significant Potlatch stockholdings of descendants of the founding families and other long-term holders, approval of the amendment by the holders of a majority of the outstanding shares was assured. The exact vote count is not publicly available.

In summary, current Potlatch management is not only locked in, but has the ability to continue in office even after disposing of a substantial amount of the controlling group's holdings.

B. The Times Mirror Company

Early this year, Times Mirror called a special meeting of shareholders for Wednesday, February 12, 1986, to obtain approval of a proposed change in the state of incorporation of the Company from California to Delaware and the adoption of a number of antitakeover measures.

The proposal involved the adoption of a series of anti-takeover measures (some of which are not permitted under California law -- hence the proposed reincorporation in Delaware). These included:

1. A classified Board of Directors.

2. Removal of directors only for cause (and only by supermajority vote if proposed by a "related" person).

3. A supermajority vote on certain business combinations.

4. Elimination of the power of shareholders to call special meetings.

5. Advance notice procedures for shareholder nominations and proposals.

6. Relevant factors to be considered by the Board.

7. An 80% supermajority vote on amendment of certain charter and by-law provisions.

Management of Times Mirror sought to justify the adoption of these antitakeover measures on the grounds that they are

intended to reduce the Company's vulnerability to unsolicited or hostile attempts to obtain control of the Company, and to increase the likelihood that shareholders will receive a fair price for their shares in transactions relating to such attempts. Management stated that other companies and their shareholders have been subjected to various "tactics" which would be contrary to the best interests of Times Mirror, and its shareholders. By way of example, Management stated that "outsiders" frequently accumulate substantial stock positions in public corporations in order to force a merger or other business combination in which certain of the corporation's shareholders receive less valuable consideration for their shares than other shareholders, or to force the corporation itself to repurchase the outsider's block at a premium.

Insofar as Management of Times Mirror wished to protect the Company's shareholders from the coercion of a highly front-end-loaded two-tier offer, there are other means to achieve this objective including, for example, provisions that in effect would require any person who acquired control of the Company to offer a fair price for the shares held by the remaining shareholders. But the Times Mirror proposal goes much further. Its anti-takeover measures proposal would discourage bona fide offers for the Company's shares, including cash offers for all outstanding shares, which shareholders should have the opportunity to consider.

Insofar as Times Mirror Management sought to prevent an outsider from forcing the corporation itself to repurchase the outsider's block at a premium, the Board of Directors of the Company has the power to prevent such a transaction simply by not agreeing to it.

Management stated that the "suddenness of a tender or exchange offer or other hostile attempt to acquire control of the Company may often deprive the shareholders of an adequate opportunity to evaluate the merits of the proposed transaction." Federal legislation and regulation in this area that is applicable to the Company is designed to and does give shareholders that opportunity.

The Company's Board of Directors stated its support for the concept that corporations have the social responsibility to consider the broad impact of corporate transactions on various constituencies. The Board views this as particularly true for Times Mirror, given the public interest served by its media operations. The proposal included a proposed charter provision that instructs the Board, when evaluating certain proposed business transactions, to consider the best interests of the Company, its shareholders, and all relevant factors, including not only those that are generally regarded as the affecting constituencies of a business corporation but also

"freedom of the press" and "the independence and integrity of the Company's media operations."

It is ironic indeed that a Board of Directors so concerned with freedom of the press and the independence and integrity of the Company's media operations should find it appropriate -- by approving management's proposal and recommending its approval by shareholders -- to abolish the freedoms of the Company's shareholders, including specifically their freedom of assembly (through their ability to hold shareholders' meetings), their freedom to be represented by directors of their choice (through an annual election of all directors and the power of removal), and their freedom to act on corporate matters by majority vote (without a minority veto).

Those provisions of the Times Mirror proposal that impose supermajority shareholder voting requirements are particularly offensive. The Company's proxy statement recited that executive officers and directors of Times Mirror as a group beneficially own approximately 41% of the Company's outstanding common stock, including shares held by the trustees of the Chandler family trusts. In view of these concentrated family holdings, approval of any management proposal by majority shareholder vote is assured. However, it is unfair to the public shareholders to allow this present

majority to impose supermajority voting requirements that continue without limit in time and may not be altered or amended by a subsequent majority shareholder vote.

As is clear, the Times Mirror proposal is completely unfair to public shareholders in allowing the inside managers and directors to insulate themselves and their actions from effective challenge. Like Potlatch, this case illustrates how existing managements are abusing the corporate governance process to change the fundamental nature of modern American corporations by eliminating involvement by public shareholders.

Unfortunately, the Potlatch and Times Mirror actions are not isolated incidences. In the last two years, 773 corporations have adopted roughly 1100 anti-takeover provisions. Obviously, several companies have doubled up on these shark repellants. Indeed, approximately 135 companies account for over 72% of the provisions. Roughly one quarter of these 135 are among the Fortune 150.

The most disturbing trend in anti-takeover provisions is the adoption of poison pills. Since November 1985, when the Delaware court upheld the legality of Household's poison pill, more than 80 corporations have adopted some form of one. Again, I am not referring to inconsequential corporations --

roughly 10% of the Fortune 50 recently have adopted poison pills.

As this summary shows, the conduct of American corporations is increasingly being determined by existing control groups; there is almost no way to achieve change without their consent. Simply stated, corporation after corporation is in effect locking itself up for perpetuity. Such a revolutionary change in the dynamics of American capitalism should not be allowed to go unnoticed. Indeed, one must question whether it should be allowed at all.

There has been a long tradition in this country of corporate self-regulation. It has been fulfilled through various forms of accountability to owners -- through meeting the New York Stock Exchange's one-share/one-vote requirement, through shareholder participation in annual and special meetings, and through general respect for the principle of public ownership. The anti-takeover measures discussed in this statement are designed to reduce or even eliminate that accountability. Poison pills, in particular, are totally antithetical to the interests of public shareholders. The fact that incumbent managers and directors of some of the largest American companies are adopting such measures shows that they are totally ignoring their responsibility to protect owners' rights. Unless the majority owners -- the institutional investors -- take steps to reverse this pattern, it will fall to the government by default to act as a proxy for the public interest. By definition, this will involve more law, more regulations, more red tape. There is sufficient law already in place to guide institutional owners in their duties. They should heed it.

Mr. LUKEN. I take it from the testimony, or would summarize it, in part, the testimony of the last two witnesses, that there is an erosion of shareholder rights that is going on, and the part that pension plans play in the picture is an important part of it, that the poison pills, other antitakeover measures that are being passed willy-nilly, according to your testimony—and we will ask others to comment on it—are locking in management in many, many cases. And the passive nature of the pension plan administrators are contributing to that, and the possible reasons for the passive nature of the administrators is potential conflicts of interest.

For example, a bank would be a money manager. Is that right? The bank might have a commercial client, a corporation, and at the same time administering the pension plan of that corporation. Is that the type of thing we are talking about, a built-in conflict of interest? Mr. Monks or Mr. Heard?

Mr. HEARD. Yes, sir. And I would add, Mr. Luken, in the case of banks and insurance companies, there are multiple relationships that go beyond simply the pension fund management relationship. The bank may on the commercial side be a lender to the company, an insurance company, may be an insurance underwriter. And although there are in many cases protections built in—in the case of banks, for example, the so-called "Chinese wall"—it does not always work.

On the investments side, people don't always have to feel—there does not have to be overt pressure. There can be a sense that a potential client or an existing client might be offended. So that complicates the matter.

Mr. LUKEN. So that contributes to the passive nature. I believe that was what Mr. Monks was referring to—I believe you did also, Mr. Heard—that there just is not the incentive which has been considered an integral part of a shareholder interest in a corporation, that the shareholders who are noninstitutional would be much more likely to take an interest in the overall corporate health other than perhaps short-term returns than would be the institutional investor. Is that what you were saying?

Mr. HEARD. I wouldn't say that of every single institution. As I said in my testimony, some institutions are still voting independently and are willing to take some heat from their clients when they have to because they feel that they have fiduciary responsibilities that they are going to live up to.

But if you look at the numbers, it is clear that there are many that are not.

Mr. LUKEN. If we look at the whole picture, you're saying that that would be the general observation?

Mr. HEARD. That is correct.

Mr. MONKS. Mr. Luken, as former chairman of a substantial trust company, I have had to deal with these problems from the bank's point of view, and let me speak to my own experience. Banks are service institutes; increasingly as the traditional bank businesses are being practiced by others, banks have attempted to intensify the relationship between themselves and their principal clients by providing services.

Now, these services range widely. One of them turns out to be of increasing importance, which is acting as a money manager; 10

years ago this was not at all important. And nowadays it is a very significant source of revenue, and some large important American banks, including the one Mr. Cowles represents, have a very significant portion of their total earnings coming from their fiduciary activities. This was never the case 10 years ago.

The problem with voting, very simply, is that nobody gets paid for it. There is not any incentive for people to take upon themselves a burden, controversiality, setting up of a separate department, if the result of that is going to be strictly an overhead expense and exasperation of their clients.

Mr. LUKEN. Can we stop there? Does someone have a reaction to that particular point, I suspect? Mr. Cowles.

Mr. COWLES. Thank you, Mr. Chairman.

Mr. LUKEN. we will get back to you, but so we can sharpen the exchange a little bit, let's deal with the issues as they come up.

Mr. COWLES. I want to address a remark that Mr. Monks just made. There is a misconception on the table; 25 years ago, when I joined Bankers Trust Co., we managed 25 percent of the then-pension assets in the country. It is not just the last 10 years. My institution for a long period of time, it has been very involved.

One of the previous witnesses also was quoting an American Bankers Association spokesman at Senator Metzenbaum's hearings in 1978. I would remind every one present that these kinds of issues—poison pills, golden parachute—did not exist in corporate proxies as far back as 1978, but 99.9 percent of proxies in 1978 were in fact election of directors, appointment of auditors, and such other business as may come before the board.

Second, Mr. Minton apparently said that he did not know of a bank that had ever voted against management. I can assure you that my bank had and still does frequently. It is a question that is asked of our chairman at every year's annual meeting. He always has the statistics. It runs 60 and 70 times a year.

Now, given the fact that we are only voting proxies on those securities where we have investment discretion—and that is a common misunderstanding—it is not all of the equities where we are trustee because there are other people managing chunks of those.

Mr. LUKEN. Perhaps the question should be not whether it is done frequently or commonly or regularly.

Mr. COWLES. I do not know that necessarily it is common to have on proxies contentious issues. It is becoming more common, yes.

But I think Mr. Heard's statistics were that it was some 250 proxies in 1985. My institution may have owned 30 or 40 of the companies represented by those 250 proxies. Without seeing the list, I would not know, as a practical matter.

Mr. LUKEN. The point that Mr. Monks made, do you see that as important that there is no monetary gain for voting, therefore there is a disinterest in voting, in taking an interest in voting, investigating the issues because there is no monetary reward for the fiduciary? That's the point. Is that an important point? And I ask that out of interest from one who is not sophisticated, obviously, in it.

Mr. COWLES. I agree with Mr. Monks. There is no monetary interest in voting the proxies. There is monetary interest in provid-

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ing services to the employees benefit community. If you do so, you damn well better follow the guidelines of ERISA, which require that you vote proxies.

I believe you have a duty to vote proxies. I believe that those corporate sponsors who retain you to manage money in fact believe you have a duty and a responsibility to vote those proxies responsibly. It is part of being a fiduciary. There is no specific economic benefit of that one piece of activity, I agree with that.

Mr. LUKEN. Mr. Binns.

Mr. BINNS. I would like to emphasize that from the standpoint of the plan sponsor, from the standpoint of General Motors and other plan sponsors with whom I am familiar, the basic approach is that you are hiring an investment manager and paying a fee and that that fee includes the full range of services that the investment manager should perform to carry out properly his fiduciary responsibilities.

Our view is that that includes the following of important issues in relation to the companies that the investment manager chooses to hold in the portfolio and making decisions about voting the proxies. And while there may be some investment manager that would prefer to be relieved of that responsibility, most that I have talked to—and we do talk to them all about this—accept that that is part of their function and accepted it that even before ERISA.

Mr. LUKEN. If they were to be relieved, who would then carry out that responsibility?

Mr. BINNS. I think some others on this panel have some suggestions in that regard. But I think, from the standpoint of the groups I represent, we feel that the present system is appropriate.

Mr. LUKEN. I think the kinds of questions that we might be inclined to address toward you is that you might be glossing over the difficult questions. I think that response might buttress that observation. As part of your answer you said that they don't want to be relieved of that obligation but some do want to be relieved of that obligation. I think the important question is, if they are relieved, who would carry it out?

Mr. BINNS. The principal suggestion, or a principal suggestion, that has been made is that then the plan sponsors should take that voting responsibility—which raises another host of questions. The plan sponsor could also be subject to pressures of one sort or many different sorts, and there is no guarantee that that would insulate the voting process from pressure.

Mr. LUKEN. It would be quite a different type.

Mr. BINNS. There would have to be a complete staff, and many plan sponsors would not have adequate staff to properly do that job.

Mr. LUKEN. If they don't have the adequate staff to do that job, then how would they have the adequate staff to monitor what the money managers do?

Mr. BINNS. I made a check on our own holdings we have in our pension fund, and it is the largest, probably the largest private pension fund in the country. But the GM fund—and this is the one where I have some concrete statistics—holds about 4,000 different common stocks in our pension fund. This is the overwhelming majority of all of the investable stocks in the country. And for us to

attempt to monitor and vote on each on the issues that come up in each of those 4,000 stocks would be an immense undertaking.

We feel that the manager, investment management firm, bank, or other firm that has decided to buy a particular stock and continue to hold it is the one that is following that particular company and is in the best position to vote the stock and should follow the traditional trust principles and trust law and the specific rule in ERISA that they have to exercise their fiduciary responsibilities in the best interests of the beneficiaries of the plan.

Mr. LUKEN. We have already heard the shuteyed sentry's observation, which is some commentary on that enforcement. Let's get back to that in a minute.

Mr. Bransford.

Mr. BRANSFORD. I would like to make one or two comments very briefly. I always enjoy coming——

Mr. LUKEN. Don't make them too brief. That's all right.

Mr. BRANSFORD. I always enjoy coming to Washington, particularly being on a panel like this, because there are certain things that happen, like the leaps of logic without facts, that I find rather interesting, and certain guilt-by-association and accusations that end up being made. And I keep looking for the body of fact that Mr. Heard has.

One of the leaps of logic I find rather interesting is that by definition a vote either for an antitakeover or against an antitakeover is on its face good or bad. But there are circumstances that one has to take into consideration. I am not in favor or against antitakeover votes. I think that you have to take each on its own merits. But it is an interesting extrapolation of some statistics out of a survey that I am not sure really necessarily prove a point.

Second, the sense that people are shirking a fiduciary responsibility is pretty strong language, to say the least. I happen to think highly of the work done by the Department of Labor and the SEC; they are not "shuteyed sentries," at least the individuals they have had in my operations for the last 16 years. They are very vigilant.

The erosion of shareholder rights is something where, again, I am not sure that we have a body of fact to tell us what has happened. I would agree that this is an area that warrants debate and warrants discussion, to be sure that the interests of plan participants are being looked after properly.

I would reiterate one point that I made in the commentary that I had, in my oral commentary and also written. We are dealing primarily with a situation of being investors versus being managers. And if there is a sense that corporate America has an interest in managing the corporations in which they are investing, that tends to be a little bit different from the experience I have had in the past and, I would suggest, not necessarily what most people are doing.

There also was a comment made by the chairman in the opening remarks that suggested that it was not unusual to have more than 10 percent of—let me go back and see if I can find it here—it is not unusual for individual managers to control in excess of 10 percent of a given corporation's stock. I would argue that that is very un-

usual when that happens. That is definitely the exception as opposed to the rule.

Mr. LUKEN. If I might react to what you have said. You say that there is not any proof of a shirking of responsibility. My observation is the question has been raised by the totality of the testimony as to whether there is any recognition of a fiduciary responsibility in this particular case.

I am not an expert on this kind of fiduciary responsibility, but I have had some experience with fiduciary responsibilities and with conflicts of interest. It seems, you know, there is some substance to the observation that because of the conflicts of interest, because of the great number of interests of the managers here, that there is a passive—and Mr. Monks and Mr. Heard have made the point, not exactly the same, but they have made the point—that there just does not seem to be any incentive, which is what we look at, any incentive to vigorously carry out a particular fiduciary responsibility.

What is that fiduciary responsibility? I might say what you are saying is there is not any proof that anybody is shirking their responsibility but we don't know what their responsibility really is.

Mr. BRANSFORD. I think that is a legitimate observation. I think there is a strong sense that the vast majority of the investment management community fulfills its fiduciary obligation not just based on what is stated law but based on the obligation that we feel as professionals in this business. Having been on the side——

Mr. LUKEN. May I observe that, having said that, you have not said very much. It may mean something to you but it——

Mr. BRANSFORD. If we are trying to suggest here that in fact something is going wrong, I do not see the body of fact that says it, and I think there is a strong sense of vigilance on the part of the vast majority of institutional investment managers to do what is best for plan participants.

Mr. LUKEN. I think Mr. Monks, I believe it was, or Mr. Heard, seemed to make a pretty good case with reference to antitakeover, poison pills, and so on. You say you don't know whether they are good or bad. But they at least made a case that they tend to be running rampant and that the institutional investor is part of the cause of those antitakeover devices running rampant, and that this does tend to lock in management and therefore might be characterized as an antishareholder kind of thing.

I am talking too much. There are others here who ought to have an opportunity.

Professor Frankel, would you want to chime in at this point?

Ms. FRANKEL. Just two points. Clearly, managing fiduciaries who decide to buy the shares and monitor the management have the expertise. And so from that point of view, they are the best qualified to vote the shares. Also, notwithstanding the fact that they are not paid for voting, they are paid for performance. The voting is part of the services for which they are paid. I am not so sure that participants who don't have expertise and certainly do not have the time and have a lesser stake in the particular voting of a stock would be better suited unless, for example, it were a takeover, in which case they may have a substantial interest as employees.

The main question is conflict of interest. My sense is, without empirical data, that there may be conflict of interest. So perhaps we should focus on how to resolve that, how to find avenues to mitigate that problem.

Mr. LUKEN. Does anybody want to comment on that?

Mr. STRAW. I did not want to comment on that, but on another question you raised earlier.

Mr. LUKEN. All right. We haven't heard from you, so you are certainly entitled.

Mr. STRAW. You asked the question who should be responsible for voting the stock proxies. There is some question as to who should be doing that. I start from the premise that this ought to be done by plan beneficiaries or workers themselves.

Mr. LUKEN. Is it being done now?

Mr. STRAW. No, it's not being done. It ought to be done that way. Workers and plan beneficiaries, with a little bit of training, have the capability of making these decisions as well as any of these investment managers. And I will give you an example of what I am talking about.

Mr. LUKEN. Can you outline how you would change the system?

Mr. STRAW. We had one of the largest worker participation projects in the United States up until 1983. We had something like 70,000 workers involved in making decisions about technology, health care costs and the everyday operations of the businesses in the Bell System. What I am suggesting is that the same principle can be applied to the pension plan. The beneficiaries can make these decisions about voting the proxies the same as any of the investment managers, with a little bit of training, and a little bit of direction. It takes time, but it can be done.

Mr. LUKEN. Of course, yours is representing the Communication Workers. Right?

Mr. STRAW. I am here representing the Communication Workers, yes.

Mr. LUKEN. Your particular fund.

Mr. STRAW. Yes.

Mr. LUKEN. So you have a mechanism there that many of the funds don't have.

Mr. STRAW. This may require legislation. But the concept is sound. Workers can make the decisions. They need help, but they are capable of making those decisions.

Mr. LUKEN. Professor Frankel and then Mr. Cowles.

Ms. FRANKEL. My question is, can't the workers negotiate voting rights as part of the pension arrangements with the management or with the plan sponsor. If they can negotiate the acquisition of this right——

Mr. STRAW. We do that all the time. Every day almost, we make decisions on what kind of technology to introduce into the work place and workers make decisions.

Ms. FRANKEL. In this particular case, why don't you simply negotiate the right to vote the portfolio?

Mr. STRAW. That is easy to say, but it takes two to negotiate a contract.

Ms. FRANKEL. It is a question of the price. How much are you willing to pay for this right?

Mr. STRAW. I don't know about that. I think it is more than just that. I think it is a power struggle, and unions do not have that much power in our society. They need help, some legislation, as they do in many other countries. But we just don't have the muscle to do that, really, in my opinion.

Mr. LUKEN. Mr. Cowles.

Mr. COWLES. Just a practical observation or two on the concept of having participants and beneficiaries vote proxies. One mechanism would be to pass through, as frequently is done in own company stock options under savings plans. A vast majority of those are pass throughs. That is, own stock going through to the plan participants. Taking an entire portfolio of equity securities and passing the proxies through becomes an unbelievably expensive administrative burden.

Frankly, I am not sure it would work. I am not sure that you would even get 20 to 30 percent of the proxies returned, which leads you to a committee of representative employees to represent that constituency. I know of two circumstances where something similar to that is being done. One of them is TIAA, the Teachers Insurance & Annuity Association, where in fact there is a board of trustees who are elected. They are academics. Keep that in mind because I think that perhaps makes it work.

The other one is, it happens to be, a money center bank in New York City. It is not my institution. They have had a committee voting proxies on a marketbasket, if you will, of equity securities for a number of years. They have never appointed anyone to the committee who has not tried almost immediately to get off the committee, feeling unqualified to represent their fellow employees, feeling unqualified to in fact read proxies and determine even what the issues are, to say nothing of how to vote them.

So there are some practical impediments is the only point I want to make.

Mr. LUKEN. Did you want to make a comment?

Mr. HEARD. Just one thought, Mr. Chairman. There is another option, which is to have participants or beneficiaries play some role in shaping the policy, in articulating a policy which then investment managers would be told to apply, and there would be some accountability for applying that policy.

Mr. LUKEN. I was interested in Mr. Machold's observation that in the absence of voting rights, a share of common stock is a feeble security, no more than a perpetual loan without the assurance of any return.

Now, most witnesses agree that it's too cumbersome for beneficiaries to vote and too costly for managers of large funds to take an interest in how well companies are managed, because they hold stocks in 150 to 300 companies. Where does that leave us? Is the vote important? Does it only have a value in the case of takeover measures? Has it contributed, Mr. Cowles and Mr. Machold? Has it contributed? Is there an epidemic of antitakeover measures?

Mr. MACHOLD. Yes.

Mr. LUKEN. Mr. Cowles, would you agree?

Mr. COWLES. I cannot define epidemic.

Mr. LUKEN. Use your own language. Would you respond to the question?

Mr. COWLES. There are more and more of these proposals finding their way onto corporate proxies, clearly. The statistic of 250 in 1985 is a large number in relation to 1984, which I am sure was a large number in relation to 1983, and so on.

Mr. LUKEN. Should we be concerned about that, that it has happened and it seems to be going on apace?

Mr. COWLES. I think there should be public debate on the issue, and I think this debate this morning is part of that public debate.

With respect to is there value in the right to vote a stock, there is a stock listed on the New York Stock Exchange where there is a class A and a class B. It has been there for years and years. They trade at a 50-cent difference in price. One has the vote, the other doesn't, which would lead you to the evaluation that it is worth 50 cents a share.

There is a member of the investment management community who is suggesting unbundling the equity ownership of corporate America with the voting rights with respect to those securities. He says, I suspect, somewhat with tongue in cheek, then managers could sell the vote to the highest bidder, presumably, and I am not sure that that is in anybody's best interest.

Mr. LUKEN. Mr. Machold.

Mr. MACHOLD. I cannot speak for Mr. Heard. He has done more work on this than I have. But I think the value of the vote in some types of companies like utilities and others is likely to be very small because in those industries much of what management does is highly regulated. In other types of industries, asset-based industries, or in companies which have very low inside ownership, the value of the vote can be higher. It depends on the circumstances in the company. We can sell the vote. You can do it through a loan. You can loan your stock to somebody for a period of time and they can vote it. We have had cases where people have offered us as much as 10 percent of the price of the stock for certain instances in order to vote that is not on a controversial tender offer, that is just in the case of a corporate restructuring.

Mr. LUKEN. I am going to call on the gentleman from Massachusetts. But, Mr. Heard, did you want to add something?

Mr. HEARD. If I could obviously, in five minutes I cannot present all of the data that we have collected with respect to recent trends on antitakeover proposals and trends on institutional voting. But if I could just give you a few more numbers which I think buttress the case that I tried to make.

As I said, we found more than 250 companies in the first 9 months of 1985 that proposed antitakeover measures. We found that about 95 percent of the measures proposed were adopted. Some measures obviously have a larger impact on shareholder rights than others, and in some cases it might be possible for responsible fiduciaries to justify a vote for an antitakeover measure. I did not mean to say, and I did not say, that every antitakeover measure that one would vote on disenfranchises shareholders.

What I did say, though, and I would like to reiterate it, is that almost all of these proposals are passing, irrespective of their nature. They are passing in companies that have very high levels of institutional ownership. If you look at the levels of institutional ownership and you look at the voting results which we get, it is dif-

ficult to draw any other conclusion than the conclusion that I drew, namely, that many fiduciaries are voting for all kinds of antitakeover measures.

We have recently compiled data for the S&P 500 companies as of late 1985. Here is what we found: 146 of the S&P 500 companies now have fair-price provisions in their charters, and that compares with only 85 as of late 1984. More than 200 of the S&P 500 companies now have classified boards of directors, and almost as many limit the rights of shareholders to amend the bylaws or call special meetings of shareholders.

More than 300 of the S&P 500 companies now have the authority to issue blank-check preferred stock which can and has been used to create poison pills. More than 40 S&P 500 companies now have poison pills, and these are never submitted to shareholders for their ratification. This compares with only four S&P 500 companies as of late 1984, and the number of companies with poison pills is growing every day. If you looked at all public companies rather than just S&P 500 companies—it is probably near 100 today.

Mr. LUKEN. Yes, Mr. Monks.

Mr. MONKS. It is important to understand the background of the ERISA law in the voting responsibility. As a humorous aside, you may remember that one of the Members from Massachusetts—not your colleague from Massachusetts—said that ERISA means "every rotten idea since Adam." That was a Member from Berkshire County. The ERISA statute was passed in the background of concern over whether beneficiaries' rights could effectively be protected.

Mr. LUKEN. You cannot dangle that. Tell him whom you are referring to.

Mr. MONKS. The Member from Berkshire County, Silvio Conte.

Mr. LUKEN. He was speaking tongue in cheek at the time.

Mr. MONKS. I am sure. He has a well-known sense of humor.

The statute was concerned with creating a structure, Mr. Chairman, within which it was possible to have a measure of confidence about the protection of the value and the rights of beneficiaries, and it codified the common-law trust. It required that it be an instrument in writing, that there be a trustee, that there be a formal acceptance of the trust, and that whatever was of value—that is the right to trade the stock or the actual monetary value of the vote—would be held by a trustee.

Now, the inclination was to say that the Congress in its wisdom wanted to have a single responsible person to protect all assets. They wanted to avoid the kind of pressure that might occur if you had passed through the voting rights.

There is a very limited exception to this, section 404(c) which governs a few highly idiosyncratic special-purpose plans. But the preponderance of plans under the law require that the trustee exercise the right to vote.

The question then you have raised, Mr. Chairman, is who should exercise it. The point of economic incentive I think has been very adequately summarized in your own comments. In fact, several different patterns obtain. The principle obligation is the plan sponsor's. The plan sponsor can retain the right to vote. He can dele-

gate it to the master trustee bank; he can delegate it to the money manager. In fact, all three patterns occur.

It is my experience, Mr. Chairman, that in no instance is additional consideration paid to a master trustee if he is also given the obligation to vote. Nor is there additional compensation given to a money manager if he is given the obligation to vote. So the obligation to vote is ancillary to a principle and more important commercial relationship. That has been the central point.

It therefore is my belief that it is important to require—and it may be that the court should require this, it may be that the Department of Labor if in its wisdom this body would give them sufficient additional appropriations to enable one to be optimistic about their capacity to perform yet another task—that the Department of Labor might be able to supervise this.

But there should be somebody somewhere who is responsible for independent, fair-minded, free-of-conflict-of-interest vote in the interest of the plan participants.

Mr. LUKEN. Thank you, Mr. Monks.

The gentleman from Massachusetts.

Mr. MARKEY. Thank you, Mr. Chairman, very much.

Ms. Frankel, one of your proposals is to require the disclosure of conflicts of interest in investment manager voting. Mr. Heard has expressed his concern about conflicts as well. I think it would help the subcommittee if you could put some flesh and blood on these conflicts. Could you give us some real-life examples of actual conflicts and explain how they were resolved or how they are being resolved?

Ms. FRANKEL. My empirical data is hearsay. I am an academician. So I hear things. I cannot vouch for them. That is why I said it was my sense more than any particular case that comes to mind.

I would say this, that it seems to me especially in connection with takeovers, with poison pills, with many of these activities that require voting as a defensive mechanism, that there is a range of pressures from very delicate ones to the tremendously crass one, of saying: if you want my business, you know what to do. And that these pressures are exerted very openly. I think that is something that is going on.

My proposal was aimed—by the way, I will back up, this kind of pressure I think violates current law because it is a violation of the law to induce a fiduciary to violate his fiduciary duties. So there is a law that prohibits that, but nobody would enforce that law. Nobody would sue somebody who crassly exert such a pressure.

My proposal for a particular statute was, No. 1, to put these activities where they belong—in the "department of moral turpitude."

Mr. MARKEY. We don't have one of those in the Government, unfortunately.

Mr. LUKEN. We don't have one.

Ms. FRANKEL. Second, people will know that the information about the conflicts reached the Department of Labor through the fiduciary, and people will know that they may pay a tremendously high fine or a short prison sentence which may then make them think twice, and reduce the pressures. The pressure will not go

away, but I think—and I am just speculating—it will become less obvious; and will tone down. And that may be helpful.

Mr. MARKEY. If it is economic harm which they are suffering, why can't they just sell their shares and then just move on to another corporation?

Ms. FRANKEL. I did not follow that question.

Mr. MARKEY. If the investment manager makes a bad decision, why can't the shareholders just go elsewhere?

Ms. FRANKEL. You mean the plan sponsors?

Mr. MARKEY. Yes.

Ms. FRANKEL. There are two problems with that. No. 1, moving to another manager, it is like shutting the barn door after the horse has escaped. The harm was done.

Mr. MARKEY. Give us that one.

Ms. FRANKEL. The second problem is it that is very hard to gauge the economic loss of these takeovers, and I think that this is one of the reasons why it is easier for a plan manager to vote for management and to buckle under pressure.

Mr. MARKEY. Mr. Bransford, in your testimony you say that in recent years, particularly in a number of takeover situations, several plan sponsors have revoked the voting power of their investment managers because they disagree with the decisions of these investment managers. Can you tell us about that?

Mr. BRANSFORD. Without getting into the specific names there was a strong conviction that the investment manager was in fact doing an appropriate job, doing an effective job from an investment performance point of view, but there was a concern on a few isolated instances as to the posture that the manager was taking. So there was a selective revocation of the rights in a few particular situations.

That is unusual. That is not the order of the day; typically it is delegated.

What I might also add is the reality of what happens as opposed to the theory of what happens. Again you have to make the distinction as to whether you are an investor or whether you are in the management process, how do you invest your money, how are you trying to achieve the returns.

Mr. MARKEY. Without naming names then, can you just, like it was a law school case or a business school case, just give us company A, company B and who did what to whom, just walk us through a situation that you think is something that we should be aware of?

Mr. BRANSFORD. You can get into too involved a situation if you have a particular body of knowledge about a specific situation. As Mr. Binns was suggesting before, it is very difficult when you have a very large plan to even focus on certain issues. In cases that were referenced, there were particular beliefs that the approaches that were being taken were not things that were especially helpful or healthy ultimately on the point of view of the plan beneficiaries.

As a result, the organization made it known that the role that they wanted to play at that point in time was a much more active role than the traditional passive role they had through the delegation.

The situations involved—takeover situations, poison pill situations—that were not viewed as things that were being terribly favorable and were not in the interests of the beneficiaries. So it is the kind of thing that Mr. Heard was talking about before, but there was action taken on the part of the plan sponsor to try to influence the direction that the investment manager was taking.

Mr. MARKEY. Mr. Heard, you expressed surprise at the widespread approval of antitakeover provisions by shareholders. The implication is that the majority of shareholders or their delegates are not acting in their own best interests.

You also testified, "I have never met a reputable investment manager who believes he is fulfilling fiduciary responsibilities by supporting the adoption of measures that disenfranchise stockholders."

Has any reputable investment manager ever acknowledged pressure leading to approval of such measures?

Mr. HEARD. When I said "disenfranchise shareholders," I had in mind, Mr. Markey, the kinds of proposals that we have seen at a number of companies recently, that create two classes of voting stock, one with supervoting rights or that give time-weighted voting such that long-term shareholders end up with superior voting rights. Over time as public shares turn over and have fewer voting rights, insiders, including management, founding families, and so on, own a higher and higher proportion of the shares, such that the public shareholders are virtually or actually disenfranchised.

In addition to that, I have in mind packages of five, six, or seven antitakeover measures, the cumulative effect of which is for all practical purposes to disenfranchise public stockholders. I have never met an investment manager who thinks that voting for those kinds of proposals is in his fiduciary responsibilities——

Mr. MARKEY. But they do that.

Mr. HEARD. In some cases it has been done. I would say also, if you were to take some of the less extreme measures—fair-price proposals, for example, as I said in my prepared testimony—you can make a case, I think, that the adoption of a fair-price proposal is in shareholder interest, and I think a fiduciary could vote for a fair-price proposal and make a very strong case that he or she has fulfilled a fiduciary responsibility.

I am aware of cases—again I cannot name names—where institutions managing ERISA funds have changed their voting policies from opposition to most forms of antitakeover measures to support many forms of takeover measures. I have been told by people inside those institutions on at least three occasions that the reasons that the changes were made had to do with not wanting to offend clients. In some cases there may have been actual pressure applied. And in other cases it did not seem to have been necessary; it was just a perception within the organization that continued voting against antitakeover measures being put forward by clients was going to end up costing the firm business.

Mr. MARKEY. I have always found it ironic that we have constructed an elaborate set of rules to preserve a shareholder's right to vote on a major policy issue affecting a corporation, yet when it comes to a hostile takeover we deny that right.

One of the consequences of this voting gap may be the widespread shareholder approval of defensive tactics proposed by corporate management to prevent sudden takeovers. Many observers have expressed wonder at the willingness of shareholders to approve changes in corporate governance that reduce their control and frequently reduces the value of the stock.

Now, perhaps this is a natural reaction to the knowledge that once a takeover battle begins, shareholders are reduced to bidders at an auction with little to say about what gets offered for sale. They would prefer to take steps today to protect against future uncertainty rather than leave a corporation exposed to the whim of a takeover artist.

Is that a reasonable alternative explanation for what is going on?

Mr. HEARD. In the case of institutional investors. The research that I have read and conversations I have had with proxy solicitors who are involved in many of these fights indicate that individual investors seem to have a loyalty to management, to the company; they seem much more willing to support management on votes, even though a more dispassionate, more professional money manager looking at the same set of facts might say that it is not in the best economic interest of shareholders to support those measures.

One concern that I have about what is going on with respect to shareholder rights is that we are seeing this gradual erosion of shareholder rights, this transfer of rights from shareholders to managers and directors.

I think the long-term consequence of that may be to harm our system of corporate governance and corporate accountability, which does now give shareholders the opportunity to participate in the governance process. This transfer of rights, together with proposed changes in New York Stock Exchange rules to permit unequal voting rights for listed companies may result in a few years in a corporate governance system that has much less accountability in it than we would wish.

Mr. MARKEY. So, investment managers begin to think more and more like individuals then, advocating their own kind of independent judgment and loyalty to the corporate management?

Mr. HEARD. I think there is a difference between the individual and the investment manager. The investment managers who are voting for measures that their own experience, judgment, and empirical evidence would tell them is not in the interest of shareholders, if they are doing so as to not offend a client, clearly they are violating the law.

Individual investors may be said to be acting irrationally or on an uninformed basis or acting on the basis of emotion or whatever, but no individual who votes for an antitakeover measure under those circumstances could be said to be violating the law unless he, is acting in a fiduciary capacity.

Mr. MARKEY. I understand.

Would you like to comment on that, Professor? Do you have any insight you can give us?

Ms. FRANKEL. I think we are moving toward an era in which the individual investors will play a very small role in the market and the institution or the fiduciaries, the managers will play a much greater role.

I don't think that we can recreate a situation in which individuals will vote to recreate the scene of the 1930's. What we should be doing—unless we pass through voting to millions of pension beneficiaries (which I do not recommend) is to accept the changes in the market. I do not think that the same values that the institutional investors can take into consideration are taken into consideration by participants or by shareholders in market players and their investment decisions. This is a change that has occurred. We should deal with any problems that this change brings about.

Mr. MARKEY. I understand. Thank you very much, Mr. Chairman.

Mr. LUKEN. Thank you, Mr. Markey.

Could I pursue some of the economic issues that we have not touched upon? We have touched upon conflict of interest and other aspects of it. In the current situation with the Dow running high, there would be a temptation—perhaps, Mr. Straw, you would like to address this—where the sponsors of pension plans to reduce their contributions, especially if the value of the fund increases?

Mr. STRAW. I would say so.

Mr. LUKEN. What would be the effect of that—other witnesses here may want to testify on that—if in fact the value increases and there is a reduction of the investment that would reduce the overall level of savings? It would be a matter of policy that we might be concerned with. Perhaps you would want to comment on that first, Mr. Straw. First of all, does that happen?

Mr. STRAW. Yes.

Mr. LUKEN. When there is an increase in the value because of the Dow rising, does the level of investment by the sponsors fall back?

Mr. STRAW. We have not seen that exactly. I can only talk intelligently about AT&T. Now, in 1983 the termination value of the assets of the Bell System pension plan, including all of the operating companies, was $17 billion and the market value of those assets was $26 billion. So there was a difference of close to $9 billion, which was made up basically by the improvements in the stock market.

Now, what we see as a danger is the elimination of private pension plans in the future if the market continues to advance. If this happens, it becomes very attractive for the new sponsor to terminate the pension plans in order to get at the excessive assets. That is one thing that we see.

Now, we have not seen yet where they have reduced the contributions. So far, they have not. Many times, they do that through changing their actuarial assumptions, their investment return or their interest return. They do it that way over a period of years.

In general, the fear on our part is that private pension plans will be eliminated by firms who are trying to get at these excessive assets.

Mr. LUKEN. Do any other witnesses want to comment on that? Mr. Binns.

Mr. BINNS. Most pension plan sponsors work on the basis of long-range assumptions that they use with their actuaries to calculate pension requirements. In years of excellent investment performance, they may simply tend to offset other years in which the mar-

kets have gone in the other direction. So the typical pension plan sponsor likes to keep his flow of contributions and charge to his income statement fairly regular and is not prone, in my experience, to radically push them up and down as the markets go up and down.

I think also that when many companies use techniques in establishing the value of their pension fund to determine how much has to be put in from an actuarial standpoint, they use smoothing techniques. They will use a 5-year average of market values or something of that nature.

We have a process in GM that we use. It is a little different from that, but it has that effect, so that the full effect of a rise in the market does not immediately flow into the calculations.

Then, in general, an actuarial gain, which is what this really represents—when there is a big market increase, that represents investment performance beyond what the actuarial assumptions call for—it has to be spread over a period of time, such as 15 years.

So the idea that because the stock market went up in one-quarter or 1 year that it will result in an immediate huge drop in contributions I think just does not follow.

Mr. LUKEN. Does anybody have any comments on that particular issue? Mr. Scott.

Mr. SCOTT. Let me add a basic element of our philosophy in Colorado in the public pension fund. That is, if over a period of time—and you need a significant period of time—you can beat your actuarial assumptions through good investment performance we do not reduce contributions because we have the contributions set up which are not particularly expensive for our taxpayers or our employees. Rather, we look at benefit enhancements. We have been able to fund a Cost-of-Living Stabilization Program. We have been able to put in place health insurance programs for our retireds. We are looking at a lower retirement age. So that the trend for U.S. assets, that if we see good gains rather than lower contribution levels, we really try to pass the gains on to our members in the way of financed benefits.

Mr. LUKEN. Anybody else?

[No response.]

Mr. LUKEN. What about the question I think some of the witnesses touched upon, the question of investment in small businesses. Mr. Binns, I believe, says that when he was asked as to whether the size of some funds act as a constraint upon the investment options—specifically whether the big funds can be invested in small businesses—I would state the background, that we are concerned. I am a member of the Small Business Committee, and I and most Members of Congress are extremely concerned about the welfare of small business. We recognize that small business provides the lion's share of innovations, new jobs. We think we have a societal interest in small business continuing and prospering and being given opportunities. And this may be a strong disincentive in investment in small business, if it actually exists. Mr. Binns.

Mr. BINNS. Here I wish I could speak for many companies of the organizations I am representing here, but I do not have good statistical information on anybody's fund except the one that I work on directly, the GM fund. As I mentioned earlier, we do have through-

out the GM fund in its entirety investments in about 4,000 different companies. Obviously, a lot of those are small. In fact, 800 of those companies were worth, in the marketplace—that is, the capitalization of the companies—less than $20 million.

Now, we do this through hiring outside managers. I grant Mr. Scott's point that if you're trying to do this with your own limited inhouse staff, you might find it very difficult. But we hire some outside experts to help us in this that are skilled and experienced in investing in small companies.

Actually, we made a check of the bottom part of the market—the stocks that have market capitalizations of less than $300 million—and calculated the percentage of the GM pension fund and stocks of that degree of smallness, and found that we have a greater than market holding in small stocks.

The reason for that is that the record seems to show that small stocks do better from an investment standpoint over time. So we make a special point of trying to have investments in those companies.

We also use venture capital, where we have five managers that have invested in a number of different limited partnerships, each one of which may have 20 or 30 venture capital types of companies.

So just roughly calculating, we probably have investments in more than 500 different companies that are still in the venture capital stage. Those would all be small, growing enterprises.

Mr. LUKEN. Mr. Scott, I believe you have another view on that subject. In your prepared testimony you said that it is generally not cost effective for the larger funds to invest in smaller or less established companies.

Mr. SCOTT. That is correct, but we do that through venture capital pools. In other words, trying to do that internally would be very expensive for the return we would get, we run the whole place on 10 basic points. That compares to 50 or 60 if you use a lot of outside managers. But that forces us to deal with very large stocks, very large companies and so forth.

But we do commit a certain percentage of the portfolio to the venture capital to small companies, and those are run through venture capital funds. We do not do that internally; we give that over to a venture capital pool. So that we do make the commitment to small companies, but not a large percentage of our portfolio.

Mr. LUKEN. Does anyone on the panel believe that it is in the interest of—or that the system is geared to the way the pension, the large pensions, directed away from investments in small businesses?

Mr. MONKS. I think to the contrary, if you would care to hear some testimony to that effect.

Mr. LUKEN. Either way. We are bringing up the issue. We have had testimony that—obviously not very strong, as we have been hearing—but we have had some suggestion that that is a problem. We would like your comments either way.

Mr. MONKS. I think that Congress should be congratulated for the care with which it drafted this particular portion of the ERISA statute. Under common law, if a trustee were to invest in 10 companies and it were found that his investment in one of those companies—say, a small, risky company—was imprudent, he would be

surcharged for that one poor investment and not given credit for his nine good ones.

The Congress in its wisdom, worrying about the problems which you have addressed, changed the common law in this regard and said that to the extent that a company, as Mr. Binns has eloquently outlined, developed a comprehensive plan and, pursuant to that plan, invests in some companies that might not, standing alone, live up to the prudent standards—it might be too high-risk, it might be too small—but if taken as a whole, the investment plan is prudently calculated to carry out the investment objectives, then there is no question of surcharge.

The Congress inserted, Mr. Chairman, into the legislative history of ERISA a very substantial and specific provision in this regard. So the problems of whether pension funds invest in a small company are far more, as the last gentleman testified, ones of their staffing and administration and their philosophy about overhead than they are of legal imposition.

The law is an admirable creature to encourage and make possible investments in all kinds of opportunities in this country.

Mr. LUKEN. Everybody seems to agree with that?

Mr. BRANSFORD. I think the issue is one of a problem of supply as opposed to the one of demand for the securities. As Mr. Monks was saying, and I totally agree with him, if you look back 10 years ago, it was rare to find a situation where you had any significant portion of small-capitalization securities in one portfolio. Today it is not at all uncommon to find upwards of 10 percent included in a given portfolio, sometimes quite a bit higher than that.

Mr. LUKEN. Mr. Machold.

Mr. MACHOLD. When legislators hear the word "small business," they are thinking about something that is actually smaller than may be discussed at this table. You are talking about 6,000 publicly traded companies, maybe, and then through venture capital pools maybe another 5,000. What a legislator hears as a constituent who is really small, mom-and-pop type business, small manufacturing, subcontracting, leasing type operations.

The means of investing in them escapes large pension plans, and the reason is that those businesses tend to be transient. The bankruptcy rate of new incorporations is over 50 percent. You are talking about businesses which will rise or fall based on the individual entrepreneurial talents of the people, not on capital forces. Those people have to put their own capital in, their families' capital, and, if possible, borrow from the banks to do it. But the great majority of what legislators hear in terms of small business and the great majority of a number of people who are employed through the small business aspect of our economy, which is very important, are really even then outside of the investment stream because of the nature of the businesses.

Ms. FRANKEL. One point. I would add to the list: real estate. And I think that pension funds may be encouraged to invest more in real estate than they now do—not in mortgage bank securities but in actual real estate. Their portfolio should look more like an insurance company's portfolio because they have such a long-range life, if you will. And I don't think that they do enough of that.

Mr. LUKEN. Are there disincentives now to investing in real estate?

Ms. FRANKEL. I think it is more a question of who the managers are. The moment you pick a manager who is in the securities area, he simply—is acting in another market. And I think diversification into different markets, so that the pension funds are not linked to the fortunes of a particular market, is also valuable. It is a question of perhaps directing, suggesting, or telling plan sponsors to seek other managers.

Mr. MACHOLD. The only thing I would add, is that there is a whole range of investments—oil, gas, real estate, and others—which have marked tax advantages. So for tax-exempt investors, they provide different and lower returns than they would for somebody else. We would not buy municipal bonds for that reason.

Mr. LUKEN. That is a volatile market, too, isn't it? Tax advantages?

Mr. MACHOLD. You are the one to answer that question, not me.

Mr. LUKEN. Let me cover one other aspect of it. Some people would argue that the problem of short-term performance objectives arises because the sponsors put pressure on managers to maximize fund earnings in the short term and then high earnings allow the company to reduce contributions, an argument that was made and at least partially shot down in the following quarter or year.

Now, I believe, Mr. Bransford, in your statement you made a comment that touched upon this. You said that some plan sponsors have concluded that the investment managers are too short-term-oriented and have been making voting decisions that are not in the long-term interests of the pension plan or even of the U.S. economy.

I would like for you to elaborate on that or comment on it, and then any others who—first of all, I would like those of you who feel that there is substance to it to comment.

Mr. Bransford.

Mr. BRANSFORD. There is a natural tendency for people, even with a long set of liabilities and obligations, which is what the retirement plan is trying to match up against, to articulate the fact that the long-term performance is all that counts. However, the investment manager seems to live or die on the relatively short-term merits of his or her own performance.

Short term can be anything from several years, perhaps 2 or 3 years, out to about 5 years, which is really the context of the short term that we are dealing with here. That happens to be a natural byproduct, natural phenomenon of life that we have, that it is tough for people to think in terms of 40 and 50 years when the measurement periods in fact tend to emphasize things of a much shorter nature.

Now, I am not quite sure of the nature of your question to me. If I could get some clarification on that?

Mr. LUKEN. I want a comment on the issue. Which one of the panel members believe that there is a problem in that the money managers have too much emphasis on short-term performance and not the long-term values, the long-term health of the corporation?

Mr. MONKS. Mr. Chairman, I think this is an unfortunate implication of the statute. The statute wisely eschews any guidelines

and leaves it up to the prudent-expert rule, so-called. But in doing that, it creates a lot of pressure on plan sponsors and on managers to demonstrate a prudent process. What this has meant over a period of time is an almost irresistible tendency to keep score. And so if you have all of the magnificent electronic apparatus in place that allows you on a minute-by-minute basis to see how your portfolio is doing, can a prudent man ignore that for 1 year, for 2 years? The data is available.

Mr. LUKEN. You don't put drastic choices into the score, do you? It is just today's score?

Mr. MONKS. Yes; and as a practical matter, with a statute that talks in terms of being able to document prudence, nobody—you know, prudent men have been losing money for years; that is not the question. It is not whether you make money or lose money, it's whether you do it prudently. So how do you document prudence?

It is very difficult to say that you can be prudent and ignore the instant availability of intelligence as to the level of each one of your holdings. So this really is a way in which the statute's framework has been, I think, unfortunate.

The only way out I can see is for a few very brave plan sponsors to set a framework and say, rather in the language Mr. Binns used, to explain their philosophy of long-term investments; and in terms of the relationship with managers, let it be understood that their surveillance will be in conformity with that long-term objective. I would think over time, if some of the leading plans were able to do this, that the present unfortunate situation would be improved.

Mr. LUKEN. There was an article in Business Week in 1984 in which one of the experts was quoted as follows:

> Investment opinions are not being formed on traditional fundamental analytical tools anymore. The typical investment cycle was three to five years in the '60's. And then money managers looked for good results over a year. That became a quarter. And now it is weekly or daily.

Does anyone want to comment on that? Mr. Binns.

Mr. BINNS. Yes, I will comment that I do not agree with that. I think most plan sponsors that are doing a good job and paying attention to their business and understand it and have some professional expertise do not approach the matter of handling their investment managers in that way.

A frequent way to compare investment managers, how they are doing against each other and against different market averages, is to look at the most recent quarter, the most recent 12 months, the last 3 years, the last 5 years, and so on. And in general, I think people are more convinced by looking at the statistics for those longer periods of time.

The approach that we try to take is in dealing with an investment manager that we have hired, if we think that they are still doing what they told us that they were going to do and that it was a sensible investment process that they were proposing to follow and they still have got their personnel intact and their system operating properly, the fact that they may have gone through some rough quarters and had some bad luck or just the taking of risks did not work out in their favor, that is not a reason that we would fire them. We do not think that is appropriate. You must look at the investment results over longer periods of time.

Mr. LUKEN. A recent Forbes article mentioned that a 100-percent turnover rate is not unusual, and straight trading of stock involves commission and other costs that can run as high as 1 percent. That is a factor which would be a detriment. So, using the Forbes example of a 100-percent turnover rate, the fund has to outperform the market 1 percent a year with just to stay in place.

Does anybody agree with the Forbes critique at all? Isn't there a large turnover rate, high turnover rate in pension funds? We had some figures here somewhere. We have the figures on the annual turnover rate. In some it approaches 70 percent. Is that what you would expect, Mr. Monks, before Mr. Bransford comments?

Mr. MONKS. I think it is extraordinarily high. I would be surprised. When I practiced law, 25 percent would have been considered——

Mr. LUKEN. You practice law, too? A varied background and now——

Mr. MONKS. It is an appallingly high figure. There will be available, Mr. Luken, from the Department of Labor within about 1 month, I am told, the results of a rather extensive evaluation study that has been going on for about 18 months that will attempt, I think for the first time, to present data that would enable you to answer your questions about the correlation between turnover expense and market performance. My expectation is that this would be available within about 1 month's time.[1]

Mr. LUKEN. Mr. Bransford.

Mr. BRANSFORD. The level of turnover of investment managers themselves, which is getting back to Mr. Binns' observation, has dropped dramatically in the last 18 to 24 months, for myriad reasons. The typical plan sponsor has become more patient, more understanding in terms of the nature of the investment process. We have seen dramatically lower turnover in the actual replacement of managers.

Second, the sense that 100-percent turnover may be usual in a common stock portfolio, is on the high side, from all of the numbers that I have seen in any set of studies. Occassionally you will find situations where the style of a particular manager who tends to focus on the shorter term, may have turnover that high, but the typical numbers you see—the median turnover numbers—are below that.

On the fixed-income side, it is not at all uncommon with short term securities to see turnover numbers higher than that. But on the equity side, that would be high for a typical fund.

Mr. LUKEN. Mr. Scott.

Mr. SCOTT. We don't have that kind of turnover. The way we approach our pension fund investment management is that our biggest enemy is inflation, and if we can get a decent rate of return with diversified kinds of investments and looking at performance evaluations, if we can stay in the second quartile, we do not particularly want to chase bull markets, we like to avoid bear markets and to keep on a steady keel and move forward. If we can do that, we are not particularly concerned that we might drop into the 60th percentile or not do as good as some other pension fund.

I think it is the way you approach it, and if you are approaching it over the long term and if you really are looking at the underly-

[1] The summary of the Department of Labor's report, as well as a table summarizing pension plans' portfolio turnover may be found at page 138. Readers interested in obtaining this report should contact the Office of Pension and Welfare Benefits, Department of Labor.

ing economic security of the beneficiaries, you do not want to be chasing the top quartile.

Mr. MACHOLD. Actually, I think there is higher turnover, and I think, in part, that is due to the use of index funds and arbitraging with futures program buying and selling.

Mr. LUKEN. Isn't that part of the problem?

Mr. MACHOLD. I am not sure that is part of the problem. I am answering your question.

Mr. LUKEN. I am asking.

Mr. MACHOLD. I don't do it.

Mr. LUKEN. Arbitrage does not sound like a desirable word.

Mr. MACHOLD. People make money at it. The answer is, I think there is more in effect——

Mr. LUKEN. Long term?

Mr. MACHOLD. Of course not. A few minutes.

Mr. LUKEN. Uninitiated.

Mr. MACHOLD. I want to bring up the other point——

Mr. LUKEN. I get the impression there is a general denial that there is a short term emphasis.

Mr. MACHOLD. I did not say that. I am telling you that there is, and the people who do this kind of program stuff—we don't do it ourselves—but I think in the market in general you will see very high levels of volume in the marketplace and they reflect this kind of program buying and selling. Some of that is done by institutional investors.

I am saying yes.

Mr. LUKEN. If there is an emphasis on the short term and arbitraging, then we are not—those investments are not looking at the health of the corporation, the investments in new products, technology, those kinds of things that we might be interested in.

Mr. MACHOLD. You are saying that. They would not say that. They would say that they are perfecting the market by providing market liquidity. But I will let them say that. I do not necessarily agree with them. It is not an area that we are involved with.

Mr. LUKEN. You don't have an opinion?

Mr. MACHOLD. On that kind of short-term stuff? No, because I do not do it.

I do have an opinion on something else, which is that some of the States are now introducing laws which are backed, in large part, by corporations, which would require that in order to vote on a merger, you would not have to—you would not be able to vote if you had not held the stock for 2 years. I find that to be a disenfranchisement and very troublesome because I think lots of people can change their points of views. It may be the seller buys stocks for reasons other than for perfectly legitimate reasons. I think you disenfranchise people on an arbitrary basis. It is a mistake.

Mr. LUKEN. The States are doing this?

Mr. MACHOLD. Yes; New York State.

Mr. LUKEN. One year?

Mr. MACHOLD. Two years.

Mr. LUKEN. Two years?

Mr. MONKS. As far as the effects of ERISA, those laws would clearly—ERISA supercedes State law, so that these would be ineffective as far as ERISA clients go.

Mr. LUKEN. Does anybody have anything further on that?

Mr. MONKS. Can I speak for a second about the short-term question?

Mr. LUKEN. We are about winding down, so anybody who has anything that has not been covered, you may speak.

Mr. MONKS. It might be a conclusory comment. But it becomes very clear in the passage of time, as ERISA plans become half of the total equity in the country, that they are the market. Therefore, the notion that people out-performing the market is becoming more and more obsolete because it is impossible for the system as a whole to outperform a market of which it is a half.

Mr. LUKEN. Let me ask one more question here with regard to asset concentration. Because of the competition to beat the market, fund managers have begun to use program trading strategies to enhance their performance. The idea behind program trades, of course, is a method of arbitrage between the stock index's future and the underlying basket of stocks when there is a disparity between the prices.

These have been called detrimental to small investors because of the volatility that they can add to the market. For example, program trades were considered a factor in the 39-point drop of the Dow Jones industrial earlier this year.

How do these trading strategies affect the small investor? Does anybody have a comment?

Mr. MACHOLD. I would say that they hurt because they do not know what is going on in the marketplace. Is that what you wanted to hear? That's what you wanted to hear, isn't it?

Mr. LUKEN. All right. I think we will quit while we're ahead on that issue.

I will say it has been a very enjoyable session for me. And I appreciate everyone approaching it with such equanimity. We have been helped immensely with your advices.

I am not going to make any comment at this time that we are going to charge out with any legislation. Neither am I going to say that all of our concerns have been completely erased. Comments such as "the shuteyed sentry" are ones that we will have to dwell on, consider, even though there may or may not be a necessity for new legislation. There certainly are concerns that have been raised with reference to the enforcement of existing legislation, and concerns for the operation of the market.

On the other hand, you have reassured us in many respects also. So we congratulate you for being here and for the kind of testimony you have given. We thank you very much.

This meeting of the subcommittee is adjourned, subject to call of the Chair.

[Whereupon, at 12:05 p.m., the subcommittee was adjourned, subject to the call of the Chair.]

STUDY OF THE INVESTMENT PERFORMANCE OF ERISA PLANS

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STUDY OF INVESTMENT PERFORMANCE OF ERISA PLANS: Chapter I-1

I. EXECUTIVE SUMMARY

A. STUDY OBJECTIVES

ERISA plans now hold over $1 trillion in assets and are projected to hold $2.2 trillion (valued in 1984 dollars) in 15 years. Depending on portfolio choices, they could control 50 percent of corporate bonds and equity by the year 2000 [1]. Yet, to date, there has been no systematic study of pension portfolio allocation and performance. This occurs despite (1) a regulated environment and (2) the appearance of studies suggesting that pension investment problems may exist [2].

The purpose of this study is to evaluate the investment performance of corporate pension plans. Data for this study were made available by (1) Merrill Lynch, (2) the SEI Corporation, (3) The State Street Bank and Trust Company, and (4) CDA Investment Technologies, Inc. The data describe performance for ERISA plans and other non-ERISA investment entities covering the period 1968-1983.

The focus of the study is on pension plans rather than on the funds comprising the plans. This permits an evaluation of plan sponsor decision making as well as fund manager decision making.

The three objectives of the study are to determine:

- If pension plan performance has been appropriate, given the returns offered by capital markets;
- If ERISA has had a significant impact on plan performance; and,
- If risk-taking and turnover policies significantly affect pension plan rates of return.

We analyzed the investment performance of 120 ERISA plans, 33 endowments, and 36 public retirement plans during the period 1968-1983 using data provided by the SEI Corporation. In 1983, the sample contained $17.7 billion of ERISA plan assets, $2.2 billion of endowment fund assets, and $35.9 billion of public retirement plan assets.

We compared the returns observed in the SEI data set to a sample of 225 ERISA plans and 121 non-ERISA funds provided by Merrill Lynch, but covering a shorter period. We found the distribution of returns to be consistent. The aggregate value of corporate ERISA plans in the Merrill Lynch data set was $11.9 billion as of the third quarter of 1984.

The State Street Bank and Trust Company provided transaction data for active managers during the first quarter of 1985. CDA Investment Technologies, Inc. provided rates of return for mutual funds quoted by NASDAQ during the period 1974-1983. We augmented the mutual fund data with a sample of mutual funds from the period 1968-1983; these represented over 60 percent of mutual fund assets in 1983.

Finally, to gauge the level of returns offered by security markets over the period 1968-1983, we used the Standard & Poor 500 stock index, the Salomon Brothers High Grade Long Term Corporate Bond Index, and rates of return on small stocks, and Treasury bills provided by Ibbotson Associates, Inc.

B. MAJOR FINDINGS

A variety of risk measures and statistical models were used to produce the following inferences.

1. Pension Fund Performance

- Average risk-adjusted performance of ERISA plans (with management fees and expenses excluded [3]) over the entire 1968-1983 period was lower than the returns experienced by diversified portfolios invested in U.S. financial markets;
  - Investment performance in the post-ERISA period 1976-1983 exceeded market indices;
  - In 1973 and 1974 performance was sufficiently below the benchmark to cause the cumulative performance for the period 1968 to 1983 to be substandard;
- Over the entire period and in most individual years, corporate pension plans and jointly trusteed (Taft-Hartley) plans performed similarly, and both performed comparably to endowment funds and public pension plans;
- The investment performance of mutual funds was significantly better than that of pension funds, but there is no definitive explanation for this phenomenon; and,
- The passage of ERISA did not have any discernible effect on the investment performance of ERISA plans.

2. Plan Management Behavior

- From May 1975, when fixed minimum commissions on equity trades were eliminated, to 1983, commission charges on equity trades declined by two-thirds; simultaneously, equity portfolio turnover [4] roughly tripled for ERISA plans, endowment plans, and public pension plans and doubled for mutual funds;

- In aggregate, portfolio turnover within stock and bond portfolios had no consistent effect on total portfolio performance for the period 1968-1983, despite its cost; and,

- Portfolio reallocations, specifically switching among stocks, bonds, and cash equivalents while attempting to "time" the market, had a significant deleterious effect on portfolio performance for ERISA plans, endowment funds, and public pension plans.

C. PENSION PLAN INVESTMENT PERFORMANCE

1. Risk-Adjusted Returns

There are two generally accepted approaches to portfolio risk measurement. The first is derived from the Capital Asset Pricing Model (CAPM). The relevant risk adjustment to investment returns using this model is based on a statistical measure of the relationship between the portfolio under consideration and a broad based, market wide proxy for the "market portfolio." The second measure is simply the standard deviation of portfolio returns. The former considers only systematic risk--that is, non-diversifiable risk of a portfolio--the latter measures the total risk of the portfolio.

Our results are robust in the sense that the same general inferences can be drawn from the data whether using the CAPM approach to risk adjustment or the total risk approach. We rely more heavily on the latter, however, since the measure is less sensitive to the discretion of the analyst. The CAPM risk measure is dependent upon the choice of the market portfolio proxy. There are many alternatives, but none cope well with the problems posed by measurement of the riskiness of fixed income portfolios. The total risk approach does not require the judgmental development of market portfolio proxies.

The total risk approach is summarized by the Sharpe "reward to variability" index [5]. This index is the pension plan return less the rate on Treasury bills--a default-free asset--divided by the standard deviation of return. In computing returns, it should be emphasized that we considered the return on the total pension plan, not on individual portfolios or component pension funds. Thus, adjusting returns by total risk should not distort comparisons to benchmarks because the plans themselves should be as diversified as the benchmark market portfolios. We further evaluated the equity components of plans and the bond components of plans separately. This enabled us to draw stronger inferences regarding the behavior of pension plan sponsors, distinct from managers of the component portfolios.

The mean reward to variability index value of ERISA plans surviving the entire period 1968-1983 was 0.01 percent, annualized. The Standard and Poor 500 over the same period had an index value of 0.10 percent, and the Salomon Brothers High Grade Corporate Bond Index had a reward to variability index of -0.07 percent. This means that for every unit of risk, ERISA plans had a one basis point return in excess of the risk free rate. While the S & P stock index and the Salomon Bond index realized, respectively, a 10 basis point and a -7 basis point return per unit of risk.

ERISA plans had an average equity allocation of 57.0 percent over the period 1968-1983. A reward-to-variability measure of market benchmarks combined in the same proportion to the average annual ERISA plan asset allocations in our sample would yield an index value of 0.52 percent. This indicates that ERISA plans underperformed the market on a risk-adjusted basis. On a risk-adjusted basis there is no significant difference between corporate plans and jointly trusteed plans

The performance of ERISA plans, public plans, and endowment funds is calculated with management fees and expenses excluded. As a consequence, the reward-to-variability ratio overstates their plan performance by as much as 25 to 100 basis points.

2. Performance Variability Over Time

Year by year performance has been highly variable. In eight of the sixteen years, equity portfolios of ERISA plans have performed better than the benchmark. In nine of the sixteen years, fixed income portfolios of ERISA plans performed better than the benchmark. Unfortunately in 1973 and 1974, performance of the combined equity and fixed income portfolios was so far below standard that subsequent but modest superior performance could not compensate. Note, however, that excluding those two

years, the reward-to-variability index for ERISA plans was 0.348 while the benchmark excluding the same two years was 0.333. Thus, exclusive of 1973 and 1974, ERISA plans (excluding fees and expenses) earned risk-adjusted returns comparable to those offered by the market.

3. Comparison of ERISA Plan Performance to Mutual Funds

Prior research has suggested that mutual funds enjoy superior investment performance relative to pension plans [2]. This research did not adjust for risk differentials between mutual funds and pension plans; thus the inference was at best tenuous.

We compared the performance of a sample of mutual funds, representing over 60 percent of mutual fund assets, to ERISA plans using both the CAPM and the Sharpe measures of investment performance. We found that mutual funds outperformed ERISA plans during the period 1968-1983.

ERISA plans had a reward to variability index value of 0.01 while mutual funds had an index value of 0.11. Furthermore, mutual fund performance includes fees and expenses whereas ERISA plans do not.

This is a surprising result inasmuch as many of the same money managers manage both pension money and mutual fund money. While there are several possible explanations, the most likely candidate is that most mutual funds do not have the same scope for attempting to "time" the markets. Indeed, those mutual funds whose characteristics are most like pension funds--that is, balanced funds whose charters permit substantial reallocations among market segments--performed quite similarly to pension funds. Those that are pure stock funds, particularly aggressive growth funds, growth, and venture funds have somewhat less market segment timing discretion and, consequently, enjoyed substantially better performance than pension plans.

4. The Impact of ERISA on the Performance of ERISA Plans

To determine if ERISA had an impact on the investment performance of pension plans, we searched for changes in investment performance over time. As a basis for comparison, we used endowment plans and public employee retirement plans. Unfortunately, meaningful data on these benchmarks became available only from 1973 forward. However, for the period 1973 to 1983, we could distinguish no economically or statistically meaningful difference between the investment performance of those

plans that fell under the purview of ERISA and those that did not.

D. PLAN MANAGEMENT BEHAVIOR

1. Transaction Costs

When the New York Stock Exchange had fixed minimum commissions and the fee schedule prevailed for other organized exchanges as well, the commission cost as a percentage of principal value approximated 1.01 percent for an equity transaction. By 1983, the commission cost had dropped to 0.34 percent. This reduction in commission charges was accompanied by an increase in liquidity so that large blocks of stock could be traded with substantially smaller price impacts [6]. These changes were accompanied by dramatic growth in institutional portfolio activity. ERISA plans, endowments, and public plans tripled their equity turnover and mutual funds doubled their equity turnover between 1975 and 1983.

Not only has equity turnover increased, but bond turnover has also increased from roughly 40 percent of beginning total assets in 1975 to 101 percent in 1983.

2. Turnover

Analysis of the entire period 1968-1983 failed to demonstrate conclusively the significance of turnover as a factor in explaining total plan performance or the performance of equity and fixed income portfolios. For certain sub-periods, turnover hampered performance, and in other periods, high turnover correlated with good performance. However, turnover was significant in distinguishing the best performing plans from the worst performing plans in the post-ERISA period.

The transaction costs generated by stock and bond trading can be high. There are two components to transaction costs. The first is commission cost; the second is the market impact or execution cost associated with buying or selling securities at a price that differs from that which would otherwise prevail if the securities markets were perfectly liquid.

Market impact costs may be adequately measured as the deviation between the trade price and the volume weighted average price for the security on the day of the trade. For stocks traded on the New York Stock Exchange, the data necessary to compute such a measure is easily (but expensively) available.

Corresponding data for other exchanges and over-the-counter stock and bond markets are not readily available.

To estimate the magnitude of total transaction costs, a sample of more than 14,000 equity transactions was provided by State Street Bank and Trust Company. These were equity transactions made by active managers employed by the master trust clients of the bank. The data pertain to the first quarter of 1985.

For these managers in this period, commission costs approximated 0.18 percent of principal value of the transaction. Market impact costs averaged 0.05 percent. Total transaction costs averaged, therefore, 0.23 percent. Hence, a buy and sell, often referred to as a "roundtrip" transaction, would cost 0.46 percent. The quality of security selection must be quite good to offset costs of this magnitude.

Unfortunately, a similar analysis could not be performed for the 1968 to 1983 sample period because usable stock trading records do not extend back that far for individually managed portfolios. Nor could a similar analysis be done for bond markets. In these markets, broker-dealers charge no commissions, but earn fees from their bid-asked spreads. There is no consolidated tape containing transaction prices for fixed income securities that would enable analysts to estimate market impact resulting from broker-dealer compensation.

3. Portfolio Allocation

Over the entire period and in most years, switching amongst stock, bonds, and cash equivalents had a deleterious impact on the investment performance of ERISA plans as well as endowments and public plans. Significant shifts in portfolio composition suggest that efforts are being made to "time" the market; that is, move from stocks to cash prior to a market decline and vice versa; or to long term bonds prior to a reduction in interest rates.

Radical alterations in portfolio allocation signify departures from prior investment strategy. Frequent shifts in strategy have undesirable consequences. Indeed, we found evidence that some plans were consistently quite good at selling stocks in the quarter after they had declined and buying them after they had risen.

STUDY OF INVESTMENT PERFORMANCE OF ERISA PLANS: Chapter I-8

E. POLICY IMPLICATIONS

Though the results of our study reveal areas on which top corporate managers might beneficially focus to improve investment performance of pension plans, they do not suggest an opportunity for meaningful public policy innovations. ERISA has not created substantial difficulties for the management of pension plan assets. Nor does it appear that any expansion of legislation would improve the investment performance of ERISA plans.

STUDY OF INVESTMENT PERFORMANCE OF ERISA PLANS: Chapter I-9

FOOTNOTES

1. Richard A. Ippolito, Pensions, Economics, and Public Policy, Homewood, Il: Dow-Jones Irwin, 1986.

2. Alicia Munnell, "Who Should Manage the Assets of Collectively Bargained Pension Plans," New England Economic Review July-August 1983, 18-30.

3. Management fees and expenses generally range from 25 to 100 basis points.

4. Turnover is conventionally defined as the lower of purchases or sales divided by beginning asset value.

5. William F. Sharpe, "Mutual Fund Performance," Journal of Business, January 1966, 119-138; Investments, Englewood Cliffs, NJ: Prentice-Hall, 1985.

6. Munnell, op cit

7. Stephen A. Berkowitz and Dennis E. Logue, "Stampeding the Brokers: Causes of the Portfolio Turnover Explosion," Journal of Portfolio Management, forthcoming

Exhibit V-2
Department of Labor
Berkowitz, Logue & Associates,

Mean Equity Portfolio Turnover

	Pension Plans[1]		All SEI Funds[b]	College & University Endowment Funds[2]	Mutual Funds[3]
	Dollar Weighted Plans[a]	Unweighted Plans[a]			
1964	N.A.	9.26%	N.A.	N.A.	N.A.
1965	10.28%	9.22%	N.A.	N.A.	N.A.
1966	12.60%	12.54%	N.A.	N.A.	N.A.
1967	14.34%	17.78%	N.A.	N.A.	N.A.
1968	19.16%	19.86%	N.A.	N.A.	N.A.
1969	23.79%	21.32%	N.A.	N.A.	N.A.
1970	28.88%	25.75%	N.A.	N.A.	N.A.
1971	27.72%	28.89%	N.A.	N.A.	47.0%
1972	30.44%	31.37%	N.A.	N.A.	48.7%
1973	24.88%	27.21%	N.A.	N.A.	37.9%
1974	19.15%	20.55%	21.0%	16.5%	38.7%
1975	22.19%	27.20%	26.0%	17.0%	35.8%
1976	22.14%	26.20%	21.0%	16.1%	39.5%
1977	22.15%	24.64%	23.0%	15.1%	43.5%
1978	30.23%	29.01%	30.0%	14.3%	46.0%
1979	32.97%	35.09%	35.0%	18.0%	40.4%
1980	48.17%	49.56%	41.0%	21.7%	47.1%
1981	42.74%	46.81%	41.0%	28.0%	56.8%
1982	62.55%	63.16%	50.0%	28.0%	75.1%
1983	63.14%	70.77%	61.0%	50.6%	75.9%
1984	N.A.	N.A.	N.A.	51.8%	N.A.

1. Sources: a.) SEI Data tapes on all complete pension plans.
   b.) SEI Performance Review, 1983 All Funds.

2. Source: National Association of College and Universtiy Business Officers, Comparative Performance Study and Investment Questionnaire, various years. The dating here differs from the other samples. The others are based on calendar years, this on fiscal years, which for colleges and universities in the sample is July 1 to June 30.

3. Source: Weisenberger's Investment Companies, various years. This represents a constant sample of growth, growth and income and balanced funds.